76 FR 67440, 11/01/2011

Handbook Mailing HM-11-12

[6705-01-P]

FARM CREDIT ADMINISTRATION

Market Access Agreement

AGENCY: Farm Credit Administration.

ACTION: Notice of Draft Second Amended and Restated Market Access Agreement; request for comments.

SUMMARY: The Farm Credit Administration (FCA or we) is publishing for comment the Draft Second Amended and Restated Market Access Agreement (Draft Second Restated MAA) proposed to be entered into by all of the banks of the Farm Credit System (System or FCS) and the Federal Farm Credit Banks Funding Corporation (Funding Corporation). This Draft Second Restated MAA is an update to and would replace the Amended and Restated MAA (Amended and Restated MAA) approved by the FCA on January 9, 2003, and published in the Federal Register on January 15, 2003 (68 FR 2037). The Draft Second Restated MAA sets forth the rights and responsibilities of each of the parties when the condition of a bank falls below pre-established financial thresholds.

DATES: You may send comments on or before December 1, 2011.

ADDRESSES: There are several methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (faxes) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.

- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."

- Federal E-Rulemaking Web site: http://www.regulations.gov. Follow the instructions for submitting comments.

- Mail: Send mail to Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters.

Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

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or

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SUPPLEMENTARY INFORMATION:

System banks and the Funding Corporation entered into the original Market Access Agreement (original MAA) on September 1, 1994, to help control the risk of each System bank by outlining each party's respective rights and responsibilities in the event the condition of a System bank fell below certain financial thresholds. As part of the original MAA, System banks and the Funding Corporation agreed to periodic reviews of the terms of the MAA to consider whether any amendments were appropriate. The original MAA was updated by the parties in 2003 in the Amended and Restated MAA and received FCA approval following notice and request for public comments in the Federal Register.[1]

On December 3, 2010, the FCA Board approved amendments to the Amended and Restated MAA that would conform its provisions to the System banks' proposed Joint and Several Liability Reallocation Agreement (Reallocation Agreement) to ensure that the MAA provisions did not impede operation of the Reallocation Agreement; the amendments also provided that the MAA and the Reallocation Agreement are separate agreements, and invalidation of one does not affect the other. The FCA published these amendments in the Federal Register.[2] The proposed Reallocation Agreement is an agreement among the banks and the Funding Corporation that establishes a procedure for non-defaulting banks to pay maturing System-wide debt on behalf of defaulting banks prior to a statutory joint and several call by the FCA under section 4.4 of the Farm Credit Act of 1971, as amended (Act).[3] The FCA Board approved the proposed Reallocation Agreement on October 14, 2010, and notice of the approval was published in the Federal Register.[4] The System banks have approved the Reallocation Agreement but have not yet executed it.

The Amended and Restated MAA has a termination date of December 31, 2011. The System banks and the Funding Corporation have requested the FCA to approve the Draft Second Restated MAA at this time in order to have it approved by the parties and in place when the current agreement terminates. The FCA seeks public comment on the proposed agreement.

The Amended and Restated MAA establishes certain financial thresholds at which conditions are placed on the activities of a bank or restrictions are placed on a bank's access to participation in System-wide and consolidated obligations. The MAA establishes three categories, which are based on each bank's net collateral ratio, permanent capital ratio, and scores under the Contractual Inter-bank Performance Agreement, which is an agreement among the banks and the Funding Corporation that establishes certain financial performance criteria.

The proposed Second Restated MAA retains the same general framework and most of the provisions of the Restated and Amended MAA, updated as necessary. An important change is to section

1.05, which revises the level of the net collateral ratio that would place a bank in Category I. The revision takes into account that the FCA has increased the minimum net collateral ratio for some banks to an amount higher than the 103 percent stated in FCA regulation 12 CFR 615.5335. Revisions to the sections that refer to the Reallocation Agreement clarify that such agreement has not been executed. In addition, certain voting and quorum procedures in Article II and Article VI of the proposed Second Restated MAA will require consent or approval of all banks rather than a majority of banks; this change recognizes that there are now only five System banks and are likely to be only four System banks as of January 1, 2012.[5]

The Second Restated MAA, together with the recitals to the amendment, is as follows:

SECOND AMENDED AND RESTATED MARKET ACCESS AGREEMENT
AMONG
AgFirst Farm Credit Bank
AgriBank, FCB
CoBank, ACB
Farm Credit Bank of Texas
U.S. AgBank, FCB
And
Federal Farm Credit Banks Funding Corporation

This SECOND AMENDED AND RESTATED MARKET ACCESS AGREEMENT (the "Restated MAA") is entered into among AgFirst Farm Credit Bank, AgriBank, FCB, CoBank, ACB, the Farm Credit Bank of Texas, U.S. AgBank, FCB (collectively, the “Banks”) and the Federal Farm Credit Banks Funding Corporation (“Funding Corporation”).

WHEREAS, the Banks and the Funding Corporation entered into that certain Market Access Agreement dated September 1, 1994 and effective as of November 23, 1994, (the "Original Agreement") for the reasons stated therein; and

WHEREAS, the Original Agreement was subsequently amended by that certain Amended and Restated Market Access Agreement, dated July 1, 2003, referred to herein as the “First Restated MAA,” for the reasons stated therein; and

WHEREAS, pursuant to Sections 7.04 and 7.05 of the First Restated MAA, the Banks and the Funding Corporation have reviewed the First Restated MAA to consider whether an extension and any amendments to it are appropriate; and

WHEREAS, representatives of the Banks and the Funding Corporation met various times in connection with such review and recommended an extension of the First Restated MAA and certain amendments for presentation to the Committee; and

WHEREAS, the Committee met various times in connection with the review and recommended an extension of the First Restated MAA and certain amendments for presentation to the Banks and the Funding Corporation; and

WHEREAS, the boards of directors of the Banks and of the Funding Corporation approved this Restated MAA in principle; and

WHEREAS, thereafter, this Restated MAA was submitted to FCA for approval and to the Insurance Corporation for an expression of support; and

WHEREAS, FCA published this Restated MAA in the Federal Register and sought comments thereon; and

WHEREAS, FCA approved this Restated MAA, subject to approval of this Restated MAA by the boards of directors of the Banks and the Funding Corporation, and a notice of such approval was published in the Federal Register; and

WHEREAS, the Insurance Corporation expressed its support of this Restated MAA; and

WHEREAS, the Parties are mindful of FCA's independent authority under Section 5.17(a)(10) of the Act to ensure the safety and soundness of Banks, FCA's independent authority under Sections 4.2 and 4.9 of the Act to approve the terms of specific issuances of Debt Securities, the Insurance Corporation's independent authority under Section 5.61 of the Act to assist troubled Banks, and the Banks' independent obligations under Section 4.3(c) of the Act to maintain necessary collateral levels for Debt Securities; and

WHEREAS, the Banks are entering into this Restated MAA pursuant to, inter alia, Section 4.2(c) and (d) of the Act; and

WHEREAS, the Funding Corporation is prepared to adopt as the “conditions of participation” that it understands to be required by Section 4.9(b)(2) of the Act each Bank’s compliance with the terms and conditions of this Restated MAA; and

WHEREAS, the Funding Corporation believes the execution and implementation of this Restated MAA will materially accomplish the objectives which it has concluded are appropriate for a market access program under Section 4.9(b)(2) of the Act; and

WHEREAS, prior to the adoption of the Original Agreement, the Funding Corporation adopted and maintained in place a Market Access and Risk Alert Program designed to fulfill what it understood to be its responsibilities under Section 4.9(b)(2) of the Act with respect to determining “conditions of participation,” which Program was discontinued by the Funding Corporation in accordance with the terms of the Original Agreement; and

WHEREAS, the Funding Corporation is entering into this Restated MAA pursuant to, inter alia, Section 4.9(b)(2) of the Act; and

WHEREAS, the Parties believe that the execution and implementation of this Restated MAA will accomplish the objectives intended to be achieved by the Original Agreement,

NOW THEREFORE, in consideration of the foregoing, the mutual promises and agreements herein contained, and other good and valuable consideration, receipt of which is hereby acknowledged, the Parties, intending to be legally bound hereby, agree as follows:

ARTICLE I - CATEGORIES

Section 1.01. Scorekeeper. The Scorekeeper, for purposes of this Restated MAA, shall be the Funding Corporation.

Section 1.02. CIPA Oversight Body. The CIPA Oversight Body, for purposes of this Restated

MAA, shall be the same as the Oversight Body under Section 5.1 of CIPA.

Section 1.03. CIPA Scores. Net Composite Scores and Average Net Composite Scores, for purposes of this Restated MAA, shall be the same as those determined under Article II of CIPA and the Model referred to therein, as in effect on June 30, 2011, and as amended under CIPA or replaced by successor provisions under CIPA in the future, to the extent such future amendments or replacements are by agreement of all the Banks.

Section 1.04. Net Collateral and Permanent Capital Ratios. Each Bank shall report to the Scorekeeper within fifteen days after the end of each month its Net Collateral Ratio and Permanent Capital Ratio as of the last day of that month. Should any Bank later correct or revise, or be required to correct or revise, any past financial data in a way that would cause any Net Collateral Ratio or Permanent Capital Ratio previously reported hereunder to have been different, the Bank shall promptly report a revised Ratio to the Scorekeeper. Should the Scorekeeper consider it necessary to verify any Net Collateral Ratio or Permanent Capital Ratio, it shall so report to the Committee, or, if the Committee is not in existence, to the CIPA Oversight Body, and the Committee or the CIPA Oversight Body, as the case may be, may verify the Ratios as it deems appropriate, through reviews of Bank records by its designees (including experts or consultants retained by it) or otherwise. The reporting Bank shall cooperate in any such verification, and the other Banks shall provide such assistance in conducting any such verification as the Committee or the CIPA Oversight Body, as the case may be, may reasonably request.

Section 1.05. Category I. A Bank shall be in Category I if it (a) has an Average Net Composite Score of 50.0 or more, but less than 60.0, for the most recent calendar quarter for which an Average Net Composite Score is available, (b) has a Net Composite Score of 45.0 or more, but less than 60.0, for the most recent calendar quarter for which a Net Composite Score is available, (c) has a Net Collateral Ratio of 103.00% or more, but less than the greater of: (i) 104.00%, or (ii) 50 basis points above the minimum set by FCA for the last day of the most recent month or (d) has a Permanent Capital Ratio of 7.00% or more, but less than 8.00%, for the period ending on the last day of the most recent month.

Section 1.06. Category II. A Bank shall be in Category II if it (a) has an Average Net Composite Score of 35.0 or more, but less than 50.0, for the most recent calendar quarter for which an Average Net Composite Score is available, (b) has a Net Composite Score of 30.0 or more, but less than 45.0, for the most recent calendar quarter for which a Net Composite Score is available,(c) has a Net Collateral Ratio of 102.00% or more, but less than 103.00%, for the last day of the most recent month, (d) has a Permanent Capital Ratio of 5.00% or more, but less than 7.00%, for the period ending on the last day of the most recent month, or (e) is in Category I and has failed to provide information to the Committee as required by Article III within two Business Days after receipt of written notice from the Committee of such failure.

Section 1.07. Category III. A Bank shall be in Category III if it (a) has an Average Net Composite Score of less than 35.0 for the most recent calendar quarter for which an Average Net Composite Score is available, (b) has a Net Composite Score of less than 30.0 for the most recent calendar quarter for which a Net Composite Score is available, (c) has a Net Collateral Ratio of less than 102.00% for the last day of the most recent month, (d) has a Permanent Capital Ratio of less than 5.00% for the period ending on the last day of the most recent month, or (e) is in Category II and has failed to provide information to the Committee as required by Article III within two Business Days after receipt of written notice from the Committee of such failure.

Section 1.08. Highest Category. If a Bank would come within more than one Category by reason of the various provisions of Sections 1.05 through 1.07, it shall be considered to be in the highest-numbered Category for which it qualifies (e.g., Category III rather than Category II).

Section 1.09. Notice by Scorekeeper. Within twenty days of the end of each month, after receiving the reports due under Section 1.04 within fifteen days of the end of the prior month, the Scorekeeper shall provide to all Banks, all Associations discounting with or otherwise receiving funding from a Bank that is in Category I, Category II or Category III, FCA, the Insurance Corporation, the Funding Corporation, and either the CIPA Oversight Body or, if it is in existence, the Committee a notice identifying the Banks, if any, that are in Categories I, II and III, or stating that no Banks are in such Categories.

ARTICLE II—THE COMMITTEE

Section 2.01. Formation. A Monitoring and Advisory Committee (the "Committee") shall be formed at the instance of the CIPA Oversight Body within seven days of the date that it receives a notice from the Scorekeeper under Section 1.09 that any Bank is in Category I, Category II or Category III (unless such a Committee is already in existence). The Committee shall remain in existence thereafter for so long as the most recent notice from the Scorekeeper under Section 1.09 indicates that any Bank is in Category I, Category II or Category III. If not already in existence, the Committee may also be formed (a) at the instance of the CIPA Oversight Body at any other time, in order to consider a Continued Access Request that has been submitted or is expected to be submitted, (b) for purposes of preparing the reports described in Section 7.05, and (c) as provided for in Section 8.04(b).

Section 2.02. Composition. The Committee shall be made up of two representatives of each Bank and two representatives of the Funding Corporation. One of the representatives of each Bank shall be that Bank's representative on the CIPA Oversight Body. The other representative of each Bank shall be an individual designated by the Bank's board of directors, who may be a member of the Bank's board of directors or a senior officer of the Bank, in the discretion of the Bank's board. One of the representatives of the Funding Corporation shall be an outside director of the Funding Corporation designated by the Funding Corporation board of directors. The other representative of the Funding Corporation shall be designated by the board of directors of the Funding Corporation from among the members of its board and/or its senior officers. The removal and replacement of the Committee members designated directly by Bank boards of directors and by the Funding Corporation shall be in the sole discretion of each Bank board and of the Funding Corporation, respectively. A replacement for a member of the CIPA Oversight Body shall automatically replace such member on the Committee.

Section 2.03. Authority and Responsibilities. The Committee shall have the authority and responsibilities specified in this Article II, in Sections 1.04, 3.01, 3.02, 3.05, 3.06, 4.02, 7.05, 8.04 and 8.08, and in Article VI, and such incidental powers as are necessary and appropriate to effectuating such authority and responsibilities.

Section 2.04. Meetings. Notwithstanding anything herein to the contrary, at all times, the Banks entitled to vote on Committee business shall be all Banks other than (i) those in Category II and Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and (ii) in the case of a Bank requesting a Continued Access Decision, such Bank. The initial meeting of the Committee shall be held at the call of the Chairman of the CIPA Oversight Body or a majority of the Parties entitled to vote on Committee business. Thereafter, the Committee shall meet at such times and such places at the call of the Chairman of the Committee or a majority of the Parties entitled to vote on Committee business. For all voting and quorum purposes each Party entitled to vote on Committee business shall act through at least one of its representatives. Written notice of each meeting shall be given to each member by the

Chairman or his or her designee not less than 48 hours prior to the time of the meeting. A meeting may be held without such notice upon the signing of a waiver of notice by all of the Parties entitled to vote on Committee business. All of the Parties entitled to vote on Committee business shall constitute a quorum for the conduct of business. A meeting may be held by a telephone conference arrangement or similar communication method allowing each speaker to be heard by all others in attendance at the same time.

Section 2.05. Action Without a Meeting. Action may be taken by the Committee without a meeting if each Bank and the Funding Corporation consent in writing to consideration of a matter without a meeting and all of the Parties entitled to vote on Committee business approve the action in writing, which writings shall be kept with the minutes of the Committee.

Section 2.06. Voting. The Funding Corporation and each Bank entitled to vote on Committee business shall have one vote on Committee business. Voting on Committee business (including recommendations on Continued Access Decisions, but not the ultimate vote on Continued Access Decisions, which is addressed in Article VI) shall be by unanimity of the Parties entitled to vote on Committee business that are present (physically, by telephone conference or similar communication method allowing each speaker to be heard by all others in attendance at the same time) through at least one representative. If a Bank or the Funding Corporation has two representatives present, they shall agree in casting the vote of the Bank or the Funding Corporation, and if they cannot agree on a particular matter, that Bank or the Funding Corporation shall not cast a vote on that matter, and, in determining unanimity, shall not be counted as a Party entitled to vote on that matter.

Section 2.07. Officers. The Committee shall elect from among its members a Chairman, a Vice Chairman, a Secretary and such other officers as it shall from time to time deem appropriate. The Chairman shall chair the meetings of the Committee and have such other duties as the Committee may delegate to him or her. The Vice Chairman shall perform such duties of the Chairman as the Chairman is unable or fails to perform, and shall have such other duties as the Committee may delegate to him or her. The Secretary shall keep the minutes and maintain the minute book of the Committee. Other officers shall have such duties as the Committee may delegate to them. Should the Chairman be a representative of either a Category II or Category III Bank, such individual will no longer be eligible to serve as Chairman. The Vice Chairman will thereafter perform the duties of Chairman, and if the Vice Chairman is unable, the Committee may elect a new Chairman from among its members.

Section 2.08. Retention of Staff, Consultants and Experts. The Committee shall be authorized to retain staff, consultants and experts as it deems necessary and appropriate in its sole discretion.

Section 2.09. Expenses. Any compensation of each member of the Committee for time spent on Committee business and for his or her out-of-pocket expenses, such as travel, shall be paid by the Party that designated that member to the Committee or to the CIPA Oversight Body. All other expenses incurred by the Committee shall be borne by the Banks and assessed by the Funding Corporation based on the formula then used by the Funding Corporation to allocate its operating expenses.

Section 2.10. Custody of Records. All information received by the Committee pursuant to this Restated MAA, and all Committee minutes, shall be lodged, while not in active use by the Committee, at the Funding Corporation, and shall be deemed records of the Funding Corporation for purposes of FCA examination. The Parties agree that documents in active use by the Committee may also be examined by FCA.

ARTICLE III - PROVISION OF INFORMATION

Section 3.01. Information To Be Provided By All Banks in Categories I, II and III. If a Bank is in Category I, Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and if the prior monthly notice by the Scorekeeper did not indicate that the Bank was in any Category, then the Bank shall within thirty days of receipt of the latest notice provide to the Committee: (a) a detailed explanation of the causes of its being in that Category, (b) an action plan to improve its financial situation so that it is no longer in any of the three Categories, (c) a timetable for achieving that result, (d) at the discretion of the Committee, the materials and information listed in Attachment 1 hereto (in addition to fulfilling the other obligations specified in Attachment 1 hereto) and (e) such other pertinent materials and information as the Committee shall, within seven days of receiving notice from the Scorekeeper, request in writing from the Bank. Such Bank shall summarize, aggregate or analyze data, as well as provide raw data, in such manner as the Committee may request. Such information shall be promptly updated (without any need for a request by the Committee) whenever the facts significantly change, and shall also be updated or supplemented as the Committee so requests in writing of the Bank by such deadlines as the Committee may reasonably specify.

Section 3.02. Additional Information To Be Provided By Banks in Categories II and III. If a Bank is in Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and if the prior monthly notice by the Scorekeeper did not indicate that the Bank was in Category II or Category III, then the Bank shall within thirty days of receipt of the latest notice provide to the Committee, in addition to the information required by Section 3.01, at the discretion of the Committee, the materials and information listed in Attachment 2 hereto (in addition to fulfilling the other obligations specified in Attachment 2 hereto). Such information shall be promptly updated (without any need for a request by the Committee) whenever the facts significantly change, and shall also be updated or supplemented as the Committee so requests in writing of the Bank by such deadlines as the Committee may reasonably specify.

Section 3.03. Documents or Information Relating to Communications With FCA or the Insurance Corporation. Notwithstanding Sections 3.01 and 3.02, a Bank shall not disclose to the Committee any communications between the Bank and FCA or the Insurance Corporation, as the case may be, or documents describing such communications, except as consented to by, and subject to such restrictive conditions as may be imposed by, FCA or the Insurance Corporation, as the case may be. However, facts regarding the Bank's condition or plans that pre-existed a communication with FCA or the Insurance Corporation and then were included in such a communication are not barred from disclosure by this section. The Committee shall decide on a case-by-case basis whether to request copies of such communications and documents from FCA or the Insurance Corporation, as the case may be. Each Bank hereby consents to the disclosure of such communications and documents to the Committee if consented to by FCA or the Insurance Corporation, as the case may be. Nothing in this section shall preclude a Bank from making disclosures to the System Disclosure Agent necessary to allow the System Disclosure Agent to comply with its obligations under the securities laws or other applicable law or regulations with regard to disclosure to investors.

Section 3.04. Sources of Information; Certification. Information provided to the Committee under Sections 3.01 and 3.02 shall, to the extent applicable, be data used in the preparation of financial statements in accordance with generally accepted accounting principles, or data used in the preparation of call reports submitted to FCA pursuant to 12 C.F.R. pt. 621, as amended from time to time, or any successor thereto. A Bank shall certify, through its chief executive officer or, if there is no chief executive officer, a senior executive officer, the completeness and accuracy of all information provided to the Committee under Sections 3.01 and 3.02.

Section 3.05. Failure to Provide Information. If a Bank fails to provide information to the

Committee as and when required under Sections 3.01 and 3.02, and does not correct such failure within two Business Days of receipt of the written notice by the Committee of the failure, then the Committee shall so advise the Scorekeeper.

Section 3.06. Provision of Information to Banks. Any information provided to the Committee under Sections 3.01 and 3.02 shall be provided by the Committee to any Bank upon request. A Bank shall not have the right under this Restated MAA to obtain information directly from another Bank.

Section 3.07. Cessation of Obligations. A Bank's obligation to provide information to the Committee under Section 3.01 shall cease as soon as the Bank is no longer in Category I, Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09. A Bank's obligation to provide to the Committee information under Section 3.02 shall cease as soon as the Bank is no longer in Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09.

ARTICLE IV - RESTRICTIONS ON MARKET ACCESS

Section 4.01. Final Restrictions. As of either,

(i) the tenth day after a Bank receives a notification from the Scorekeeper that it is in Category II, as indicated in the most recent notice from the Scorekeeper under Section 1.09, if it has not by said tenth day submitted a Continued Access Request to the Committee; or

(ii) if the Bank has submitted a Continued Access Request to the Committee by the tenth day after its receipt of notice from the Scorekeeper that it is in Category II, the seventh day following the day a submitted Continued Access Request is denied,

a Bank in Category II, as indicated in the most recent notice from the Scorekeeper under Section 1.09, (a) shall be permitted to participate in issues of Debt Securities only to the extent necessary to roll over the principal (net of any original issue discount) of maturing debt, and (b) shall comply with the Additional Restrictions.

Section 4.02. Category II Interim Restrictions. From the day that a Bank receives a notice from the Scorekeeper that it is in Category II until: (a) ten days thereafter, if the Bank does not by that day submit a Continued Access Request to the Committee, or (b) if the Bank by such tenth day after it has received a notice from the Scorekeeper that it is in Category II does submit a Continued Access Request to the Committee, the seventh day following the day that notice is received by the Bank that the Continued Access Request is granted or denied, the Bank (i) may participate in issues of Debt Securities only to the extent necessary to roll over the principal (net of any original issue discount) of maturing debt unless the Committee, taking into account the criteria in Section 6.03, shall specifically authorize participation to a greater extent, and (ii) shall comply with the Additional Restrictions. Notwithstanding the foregoing, the Category II Interim Restrictions shall not go into effect if a Continued Access Request has already been granted in anticipation of the formal notice that the Bank is in Category II.

Section 4.03. FCA Action. The Final Restrictions and the Category II Interim Restrictions shall go into effect without the need for case-by-case approval by FCA.

Section 4.04. Cessation of Restrictions. The Final Restrictions and the Category II Interim Restrictions shall cease as soon as the Bank is no longer in Category II, as indicated in the most recent notice from the Scorekeeper under Section 1.09. The Bank shall continue, however, to be subject to such other obligations under this Restated MAA as may apply to it by reason of its being in another Category.

Section 4.05. Relationship to the Joint and Several Liability Reallocation Agreement. A Category II Bank shall not be subject to the Final Restrictions and Category II Interim Restrictions, to the extent that the Final Restrictions and Category II Interim Restrictions would prohibit such Category II Bank from issuing debt required to fund such Category II Bank's liabilities and obligations under the Joint and Several Liability Reallocation Agreement, if and when the Joint and Several Liability Reallocation Agreement is in effect among the Parties.

ARTICLE V - PROHIBITION OF MARKET ACCESS

Section 5.01. Final Prohibition. As of either,

(i) the tenth day after a Bank receives a notification from the Scorekeeper that it is in Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, if it has not by said tenth day submitted a Continued Access Request to the Committee; or

(ii) if the Bank has submitted a Continued Access Request to the Committee by the tenth day after its receipt of notice from the Scorekeeper that it is in Category III, the seventh day following the day a submitted Continued Access Request is denied,

a Bank in Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, (a) shall be prohibited from participating in issues of Debt Securities, and (b) shall comply with the Additional Restrictions.

Section 5.02. Category III Interim Restrictions. From the day that a Bank receives a notice from the Scorekeeper that it is in Category III until: (a) ten days thereafter, if the Bank does not by that day submit a Continued Access Request to the Committee, or (b) if the Bank by such tenth day after it has received a notice from the Scorekeeper that it is in Category III does submit a Continued Access Request to the Committee, the seventh day following the day that notice is received by the Bank that the Continued Access Request is granted or denied, the Bank (i) may participate in issues of Debt Securities only to the extent necessary to roll over the principal (net of any original issue discount) of maturing debt, and (ii) shall comply with the Additional Restrictions. Notwithstanding the foregoing, the Category III Interim Restrictions shall not go into effect if a Continued Access Request has already been granted in anticipation of the formal notice that the Bank is in Category III.

Section 5.03. FCA Action. The Category III Interim Restrictions shall go into effect without the need for case-by-case approval by FCA. The Parties agree that the Final Prohibition shall go into effect without the need for approval by FCA; provided, however, that FCA may override the Final Prohibition, for such time period up to 60 days as FCA may specify (or, if FCA does not so specify, for 60 days), by so ordering before the date upon which the Final Prohibition becomes effective pursuant to Section 5.01, and may renew such an override once only, for such time period up to 60 additional days as FCA may specify (or, if FCA does not so specify, for 60 days), by so ordering before the expiration of the initial override period. If the Final Prohibition is overridden by FCA, the Category III Interim Restrictions shall remain in effect.

Section 5.04. Cessation of Restrictions. The Final Prohibition and the Category III Interim Restrictions shall cease as soon as the Bank is no longer in Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09. The Bank shall continue, however, to be subject to such other obligations under this Restated MAA as may apply to it by reason of its being in another Category.

Section 5.05. Relationship to the Joint and Several Liability Reallocation Agreement. A Category III Bank shall not be subject to the Final Prohibition or Category III Interim Restrictions, to the extent that the Final Prohibition or Category III Interim Restrictions would prohibit such Category III Bank from issuing debt required to fund such Category III Bank's liabilities and obligations under the Joint and Several Liability Reallocation Agreement, if and when the Joint and Several Liability Reallocation Agreement is in effect among the Parties.

ARTICLE VI - CONTINUED ACCESS DECISIONS

Section 6.01. Process. The process for action on Continued Access Requests shall be as follows:

(a) Submission of Request. A Bank may submit a Continued Access Request for consideration by the Committee at any time, including (i) prior to formal notice from the Scorekeeper that it is in Category II or Category III, if the Bank anticipates such notice, and (ii) prior to the tenth day after a Bank receives a notification from the Scorekeeper that it is in Category II or the tenth day after a Bank receives a notification from the Scorekeeper that it is in Category III.

(b) Committee Recommendation. After a review of the Request, the supporting information and any other pertinent information available to the Committee, the Committee shall arrive at a recommendation regarding the Request (including, if the recommendation is to grant the Request, recommendations as to the expiration date of the Continued Access Decision and as to any conditions to be imposed on the Decision). The Funding Corporation, drawing upon its expertise and specialized knowledge, shall provide to the Committee all pertinent information in its possession (and the Banks authorize the Funding Corporation to provide such information to the Committee for its use as provided herein, and, to that limited extent only, waive their right to require the Funding Corporation to maintain the confidentiality of such information). The Committee shall send its recommendation and a statement of the reasons therefor, including a description of any considerations that were expressed for and against the recommendation by members of the Committee during its deliberations, together with the Request, the supporting information, a report of how the members of the Committee voted on the recommendation, a report by the Funding Corporation concerning its position on the recommendation, and any other material information that was considered by the Committee, to all Banks and the Funding Corporation by a nationally recognized overnight delivery service within fourteen days after receiving the Request. If the Committee fails to act within such fourteen-day period, the Continued Access Request shall be deemed forwarded to all Banks entitled to vote thereon for their consideration. If the Committee has failed to act, the Funding Corporation shall send to all Banks, within two days following the deadline for Committee action, a report concerning the position of the Funding Corporation on the Continued Access Request.

(c) Vote on the Request. Unless otherwise expressly stated herein, the Banks entitled to vote on the Request shall be all Banks other than those in Category II and Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and other than the Bank requesting the Continued Access Decision. Within ten days of receiving the Committee's recommendation and the accompanying materials (or, if the Committee failed to act within fourteen days, within ten days following the fourteenth day), the board of directors of each Bank entitled to vote on the Request, or its designee, after review of the recommendation, the accompanying materials, the report of the Funding Corporation, and any other pertinent information, shall vote to grant or deny the Request (as modified or supplemented by any recommendations of the Committee as to the expiration date of the Continued Access Decision and as to conditions to be imposed on the Decision), and shall provide written notice of its vote to the Committee. If the Committee has recommended in favor of a Continued Access Decision, the vote of a Bank shall be either to accept or reject the Committee's recommendation, including the recommended expiration date and conditions; if the Committee has recommended against a Continued Access Decision or has failed to act, the vote of a Bank shall be either to grant the Continued Access Request on the terms requested by the requesting Bank, or to deny it. Failure to vote within the ten-day period shall be considered a "no" vote. A Continued Access Request shall be granted only upon a 100% Vote within the ten-day period, and shall be considered denied if a 100% Vote is not forthcoming by that day.

(d) Notice. The Committee shall promptly provide written notice to the Parties, FCA and the Insurance Corporation of the granting or denial of the Continued Access Request, and, if the Continued Access Request was granted, of all the particulars of the Continued Access Decision.

Section 6.02. Provision of Information to FCA and the Insurance Corporation. FCA and the Insurance Corporation shall be advised by the Committee of the submission of a Continued Access Request, shall be provided by the Committee with appropriate materials relating to the Request, and shall be advised by the Committee of the recommendation made by the Committee concerning the Request.

Section 6.03. Criteria. The Committee, in arriving at its recommendation on a Continued Access Request, and the voting Banks, in voting on a Continued Access Request, shall consider (a) the present financial strength of the Bank in issue, (b) the prospects for financial recovery of the Bank in issue, (c) the probable costs of particular courses of action to the Banks and the Insurance Fund, (d) any intentions expressed by the Insurance Corporation with regard to assisting or working with the Bank in issue, (e) any existing lending commitments and any particular high-quality new lending opportunities of the Bank, (f) seasonal variations in the borrowing needs of the Bank, (g) whether the Bank's independent public accountants have included a Going Concern Qualification in the most recent combined financial statements of the Bank and its constituent Associations, and (h) any other matters deemed pertinent.

Section 6.04. Expiration Date. A Continued Access Decision shall have such expiration date as the Committee recommends and is approved by a 100% Vote. If the Committee recommends against or fails to act on a Continued Access Request, and it is subsequently approved by a 100% Vote, the expiration date of the Continued Access Decision shall be the earlier of the date requested by the Bank or 180 days from the date the Request is granted. A Continued Access Decision may be terminated prior to that date, or renewed for an additional term, upon a new recommendation by the Committee and 100% Vote.

Section 6.05. Conditions. A Continued Access Decision shall be subject to such conditions as the Committee recommends and are approved by a 100% Vote. If specifically approved by a 100% Vote, administration of the details of the conditions and ongoing refinement of the conditions to take account of changing circumstances can be left to the Committee or such subcommittee as it may establish for that purpose. Among the conditions that may be imposed on a Continued Access Decision are (a) a requirement of remedial action by the Bank, failing which the Continued Access Decision will terminate, (b) a requirement of other appropriate conduct on the part of the Bank (such as compliance with the Additional Restrictions), failing which the Continued Access Decision will terminate, and (c) specific restrictions on continued borrowing by the Bank, such as a provision allowing a Bank in Category II to borrow only for specified types of business in addition to rolling over the principal of maturing debt, or allowing such a Bank only to roll over interest on maturing debt in addition to rolling over the principal of maturing debt, or a provision allowing a Bank in Category III to roll over a portion of its maturing debt. The Committee shall be responsible for monitoring and determining compliance with conditions, and shall promptly advise the Parties of any failure by a Bank to comply with conditions. The Committee's determination with respect to compliance with conditions shall be final, until and unless overturned or modified in arbitration pursuant to Section 7.08.

Section 6.06. FCA Action. The Parties agree that a Continued Access Decision shall go into effect without the need for approval by FCA, but that FCA may override the Continued Access Decision, for such time period as FCA may specify (or, if FCA does not so specify, until a new Continued Access Decision is made pursuant to a recommendation of the Committee and a 100% Vote, in which case it is again subject to override by FCA), by so ordering at any time.

Section 6.07. Notice to FCA of Intent to File Continued Access Request. A Bank that receives notice that it is in Category III shall advise FCA, within ten days of receiving such notice, whether it intends to file a Continued Access Request.

ARTICLE VII - OTHER

Section 7.01. Conditions Precedent. This Restated MAA shall go into effect on January 1, 2012, provided, however, that on or before January 15, 2012 each Party has executed a certificate in substantially the form of Attachment 3 hereto that all of the following conditions precedent have been satisfied: (a) the delivery to the Banks of an opinion by an outside law firm reasonably acceptable to all of the Parties and in substantially the form of Attachment 4 hereto, (b) the delivery to the Funding Corporation of an opinion by an outside law firm reasonably acceptable to all of the Parties and in substantially the form of Attachment 5 hereto, (c) adoption by each of the Banks and the Funding Corporation of a resolution in substantially the form of Attachment 6 hereto, (d) action by the Insurance Corporation, through its board, expressing its support for this Restated MAA, and (e) action by FCA, through its board, approving this Restated MAA pursuant to Section 4.2(c) and Section 4.2(d) of the Act, and (without necessarily expressing any view as to the proper interpretation of Section 4.9(b)(2) of the Act) approving this Restated MAA pursuant to Section 4.9(b)(2) of the Act insofar as such approval may be required, which action shall (i) indicate that the entry into and compliance with this Restated MAA by the Funding Corporation fully satisfy such obligations as the Funding Corporation may have with respect to establishing "conditions of participation" for market access under Section 4.9(b)(2), and (ii) contain no reservations or other conditions or qualifications except for those which may be specifically agreed to by the Funding Corporation's board of directors and the other Parties.

Upon execution of its certificate, each Party shall forward a copy to the Funding Corporation, attn. General Counsel, which shall advise all other Parties when a complete set of certificates is received.

If this Restated MAA becomes effective in accordance with this Section 7.01, the First Restated MAA shall be amended and restated by this Restated MAA as of that date without further action of the Parties. If any term, provision, covenant or restriction of this Restated MAA is held by a court of competent jurisdiction or other authority to be invalid, void or unenforceable, the remainder of the terms, provisions, covenants and restrictions of this Restated MAA shall remain in full force and effect and shall in no way be affected, impaired or invalidated. If any term, provision, covenant or restriction of this Restated MAA that purports to amend a term, provision, covenant or restriction of the Original Agreement or the First Restated MAA is held by a court of competent jurisdiction or other authority to be invalid, void or unenforceable, such term, provision, covenant or restriction of the Original Agreement or the First Restated MAA shall be considered to have continued and to be continuing in full force and effect at all times since this Restated MAA has purported to be in effect. The Parties agree that notwithstanding the occurrence of any of the foregoing events they will treat, to the maximum extent permitted by law, all actions theretofore taken pursuant to this Restated MAA as valid and binding actions of the Parties.

Section 7.02. Representations and Warranties. Each Party represents and warrants to the other Parties that (a) it has duly executed and delivered this Restated MAA, (b) its performance of this Restated MAA in accordance with its terms will not conflict with or result in the breach of or violation of any of the terms or conditions of, or constitute (or with notice or lapse of time or both constitute) a default under any order, judgment or decree applicable to it, or any instrument, contract or other agreement to which it is a party or by which it is bound, (c) it is duly constituted and validly existing under the laws of the United States, (d) it has the corporate and other authority, and has obtained all necessary approvals, to enter into this Restated MAA and perform all of its obligations hereunder, and (e) its performance of this Restated MAA in accordance with its terms will not conflict with or result in the breach of or violation of any of the terms or conditions of, or constitute (or with notice or lapse of time or both constitute) a default under its charter (with respect to the Banks), or its bylaws.

Section 7.03. Additional Covenants.

(a) Each Bank agrees to notify the other Parties and the Scorekeeper if, at any time, it anticipates that within the following three months it will come to be in Category I, Category II or Category III, or will move from one Category to another.

(b) Whenever a Bank is subject to Final Restrictions, a Final Prohibition, Category II Interim Restrictions, Category III Interim Restrictions, or a Continued Access Decision, the Committee shall promptly so notify the Funding Corporation, and the Funding Corporation shall take all necessary steps to ensure that the Bank participates in issues of Debt Securities only to the extent permitted thereunder. The Funding Corporation may rely on the determination of the Committee as to whether a Bank has complied with a condition to a Continued Access Decision.

(c) Each Bank agrees that it will not at any time that it is in Category I, Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and will not without twelve months' prior notice to all other Banks and the Funding Corporation at any other time, either (i) withdraw, or (ii) modify, in a fashion that would impede the issuance of Debt Securities, the funding resolution it has adopted pursuant to Section 4.4(b) of the Act. Should a violation of this covenant be asserted, and should the Bank deny same, the funding resolution shall be deemed still to be in full effect, without modification, until arbitration of the matter is completed, and each Bank, by entering into this Restated MAA, consents to emergency injunctive relief to enforce this provision. Nothing in this Restated MAA shall be construed to restrict any Party's ability to take the position that a Bank's withdrawal or modification of its funding resolution is not authorized by law.

(d) Each Bank agrees that it will not at any time that it is in Category I, Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and will not without twelve months' prior notice to all other Banks and the System Disclosure Agent at any other time, fail to report information to the System Disclosure Agent pursuant to the Disclosure Program for the issuance of Debt Securities and for the System Disclosure Agent to have a reasonable basis for making disclosures pursuant to the Disclosure Program. Should the System Disclosure Agent assert a violation of this covenant, and should the Bank deny same, the Bank shall furnish such information as the System Disclosure Agent shall request until arbitration of the matter is completed, and each Bank, by entering into this Restated MAA, consents to emergency injunctive relief to enforce this provision. Nothing in this Restated MAA shall be construed to restrict the ability of the System Disclosure Agent to comply with its obligations under the securities laws or other applicable law or regulations with regard to disclosure to investors.

(e) Without implying that suit may be brought on any other matter, each Bank and the Funding Corporation specifically agree not to bring suit to challenge this Restated MAA or to challenge any Final Prohibition, Final Restrictions, Category II Interim Restrictions, Category III Interim Restrictions, Continued Access Decision, denial of a Continued Access Request or recommendation of the Committee with respect to a Continued Access Request arrived at in accordance with this Restated MAA. This provision shall not be construed to preclude judicial actions under the U.S. Arbitration Act, 9 U.S.C. sections 1-15, to enforce or vacate arbitration decisions rendered pursuant to Section 7.08, or for an order that arbitration proceed pursuant to Section 7.08.

(f) The Funding Corporation agrees that it will not reinstitute the Market Access and Risk Alert Program, or adopt a similar such program for so long as both (i) this Restated MAA is in effect and (ii) Section 4.9(b)(2) of the Act is not amended in a manner which would require, nor is there any other change in applicable law or regulations which would require, the Funding Corporation to establish "conditions of participation" different from those contained in this Restated MAA. Should the condition described in (ii) no longer apply and the Funding Corporation adopt a market access program, this Restated MAA shall be deemed terminated. All Banks reserve the right to argue, if the conditions described in clauses (i) or (ii) of the preceding sentence should no longer apply and the Funding Corporation should adopt such a program, that any such program adopted by the Funding Corporation is contrary to law, either because Section 4.9(b)(2) of the Act does not authorize such a program, or for any other reason, and the entry by any Bank into this Restated MAA shall not be construed as waiving such right.

(g) It is expressly agreed that the Original Agreement, FCA approval of the Original Agreement, the First Restated MAA and FCA approval of this Restated MAA do not provide any grounds for challenging FCA or Insurance Corporation actions with respect to the creation of or the conduct of receiverships or conservatorships. Without limiting the preceding statement, each Bank specifically and expressly agrees and acknowledges that it cannot, and agrees that it shall not, attempt to challenge FCA's appointment of a receiver or conservator for itself or any other System institution or FCA's or the Insurance Corporation's actions in the conduct of any receivership or conservatorship (i) on the basis of this Restated MAA or FCA's approval of this Restated MAA; or (ii) on the grounds that Category II Interim Restrictions, Final Restrictions, Category III Interim Restrictions, or Final Prohibitions were or were not imposed, whether by reason of FCA's or the Insurance Corporation's action or inaction or otherwise. The Banks jointly and severally agree that they shall indemnify and hold harmless FCA and the Insurance Corporation against all costs, expenses, and damages, including without limitation, attorneys' fees and litigation costs, resulting from any such challenge by any Party.

Section 7.04. Termination. This Restated MAA shall terminate upon the earliest of (i) December 31, 2025, (ii) an earlier date if so agreed in writing by 100% Vote of the Banks, or (iii) in the event that all Banks shall be in either Category II or Category III. Commencing a year before December 31, 2025, the Parties shall meet to consider its extension. Except as provided in Section 7.03(f), it is understood that the termination of this Restated MAA shall not affect (i) any rights and obligations of the Funding Corporation under Section 4.9(b)(2) of the Act, and (ii) any Bank's rights pursuant to any Final Restrictions, a Final Prohibition, Category II Interim Restrictions, Category III Interim Restrictions, or a Continued Access Decision then-in-effect.

Section 7.05. Periodic Review. Commencing every third anniversary of the effective date of this Restated MAA, beginning January 1, 2015, and at such more frequent intervals as the Parties may agree, the Banks and the Funding Corporation, through their boards of directors, shall conduct a formal review of this Restated MAA and consider whether any amendments to it are appropriate. In connection with such review, the Committee shall report to the boards on the operation of the Restated MAA and recommend any amendments it considers appropriate.

Section 7.06. Confidentiality. The Parties may disclose this Restated MAA and any amendments to it and any actions taken pursuant to this Restated MAA to restrict or prohibit borrowing by a Bank. All other information relating to this Restated MAA shall be kept confidential and shall be used solely for purposes of this Restated MAA, except that, to the extent permitted by applicable law and regulations, such information may be disclosed by (a) the System Disclosure Agent under the Disclosure Program, (b) a Bank, upon coordination of such disclosure with the System Disclosure Agent, as the Bank deems appropriate for purposes of the Bank's disclosures to borrowers or shareholders; (c) a Bank as deemed appropriate for purposes of disclosure to transacting parties (subject, to the extent the Bank reasonably can obtain such agreement, to such a transacting party's agreeing to keep the information confidential) of material information relating to that Bank, or (d) any Party in order to comply with legal or regulatory obligations. Notwithstanding the preceding sentence, the Parties shall make every effort, to the extent consistent with legal requirements, securities disclosure obligations and other business necessities, to preserve the confidentiality of information provided to the Committee by a Bank and designated as "Proprietary and Confidential." Any expert or consultant retained in connection with this Restated MAA shall execute a written undertaking to preserve the confidentiality of any information received in connection with this Restated MAA. Notwithstanding the foregoing, nothing in this Restated MAA shall prevent Parties from disclosing information to FCA or the Insurance Corporation.

Section 7.07. Amendments. This Restated MAA may be amended only by the written agreement of all the Parties.

Section 7.08. Dispute Resolution. All disputes between or among Parties relating to this Restated MAA shall be submitted to final and binding arbitration pursuant to the U.S. Arbitration Act, 9 U.S.C. sections 1-15, provided, however, that any recommendation by the Committee regarding a Continued Access Request (including, if the recommendation is to grant the Request, recommendations as to the expiration date of the Continued Access Decision and as to any conditions to be imposed on the Decision), and any vote by a Bank on a Continued Access Request, shall be final and not subject to arbitration. Arbitrations shall be conducted under the Commercial Arbitration Rules of the American Arbitration Association before a single arbitrator. An arbitrator shall be selected within fourteen days of the initiation of arbitration by any Party, and the arbitrator shall render a decision within thirty days of his or her selection, or as otherwise agreed to by the parties thereto.

Section 7.09. Governing Law. This Restated MAA shall be governed by and construed in accordance with the Federal laws of the United States of America, and, to the extent of the absence of Federal law, in accordance with the laws of the State of New York excluding any conflict of law provisions that would cause the law of any jurisdiction other than New York to be applied; provided, however, that in the event of any conflict between the U.S. Arbitration Act and applicable Federal or New York law, the U.S. Arbitration Act shall control.

Section 7.10. Notices. Any notices required or permitted under this Restated MAA shall be in writing and shall be deemed given if delivered in person, by e-mail, by fax or by a nationally recognized overnight courier, in each case addressed as follows, unless such address is changed by written notice hereunder:

To AgFirst Farm Credit Bank:

AgFirst Farm Credit Bank
Farm Credit Bank Building
1401 Hampton Street
Columbia, SC 29201
Attention: President and Chief Executive Officer
Fax: 803-254-1776
E-Mail:[OMITTED]

To AgriBank, FCB:

AgriBank, FCB
375 Jackson Street
St. Paul, MN 55101
Attention: President and Chief Executive Officer
Fax: 651-282-8494
E-Mail: [OMITTED]

To CoBank, ACB:

CoBank, ACB
5500 South Quebec Street
Greenwood Village, CO 80111
Attention: President and Chief Executive Officer
Fax: 303-740-4002
E-Mail: [OMITTED]

To the Farm Credit Bank of Texas:

Farm Credit Bank of Texas
4801 Plaza on the Lake Drive
Austin, TX 78746
Attention: President and Chief Executive Officer
Fax: 512-465-0775
E-Mail: [OMITTED]

To U.S. AgBank, FCB:

U.S. AgBank, FCB
Farm Credit Bank Building
245 North Waco
Wichita, KS 67202
Attention: President and Chief Executive Officer
Fax: 316-266-5126
E-Mail: [OMITTED]

To Federal Farm Credit Banks Funding Corporation:

Federal Farm Credit Banks Funding Corporation
10 Exchange Place
Suite 1401
Jersey City, NJ 07302
Attention: President and Chief Executive Officer
Fax: 201-200-8109

E-Mail: [OMITTED]

To the Farm Credit System Insurance Corporation:

Farm Credit System Insurance Corporation
1501 Farm Credit Drive
McLean, Virginia 22102
Attention: Chairman
Fax: 703-790-9088
E-Mail: [OMITTED]

To the Farm Credit Administration:

Farm Credit Administration
1501 Farm Credit Drive
McLean, Virginia 22102-5090
Attention: Chairman
Fax: 703-734-5784
E-Mail: [OMITTED]

To the CIPA Oversight Body:

At such address, fax number and e-mail address as shall be supplied to the Parties from time to time by the Chairman of the CIPA Oversight Body.

To the Committee:

At such address, fax number and e-mail address as shall be supplied by the Committee, which the Committee shall promptly transmit to each Party.

Any notice sent by the courier shall be deemed given one Business Day after depositing with the overnight courier. Any notice given in person, by e-mail, or by fax shall be deemed given instantaneously.

Section 7.11. Headings; Conjunctive/Disjunctive; Singular/Plural. The headings of any article or section of this Restated MAA are for convenience only and shall not be used to interpret any provision of the Restated MAA. Uses of the conjunctive include the disjunctive, and vice versa, unless the context clearly requires otherwise. Uses of the singular include the plural, and vice versa, unless the context clearly requires otherwise.

Section 7.12. Successors and Assigns. Except as provided in the definitions of "Bank" and "Banks" in Article IX, this Restated MAA shall inure to the benefit of and be binding upon the successors and assigns of the Parties, including entities resulting from the merger or consolidation of one or more Banks.

Section 7.13. Counterparts. This Restated MAA, and any document provided for hereunder, may be executed in one or more counterparts. Transmission by facsimile or other form of electronic transmission of an executed counterpart of this Restated MAA shall be deemed to constitute due and sufficient delivery of such counterpart.

Section 7.14. Waiver. Any provision of this Restated MAA may be waived, but only if such waiver is in writing and is signed by all Parties to this Restated MAA.

Section 7.15. Entire Agreement. Except as provisions of CIPA are cited in this Restated MAA (which provisions are expressly incorporated herein by reference), this Restated MAA sets forth the entire agreement of the Parties and supersedes all prior understandings or agreements, oral or written, among the Parties with respect to the subject matter hereof.

Section 7.16. Relation to CIPA. This Restated MAA and CIPA are separate agreements, and invalidation of one does not affect the other. Should CIPA be invalidated or terminated, the Parties will take the necessary steps to maintain those aspects of CIPA that are referred to in Sections 1.01, 1.02 and 1.03 of this Restated MAA, and to replace the CIPA Oversight Body for purposes of continued administration of this Restated MAA.

Section 7.17. Third Parties. Except as provided in Sections 2.10, 3.03, 7.03(g), 7.21 and 7.22, this Restated MAA is for the benefit of the Parties and their respective successors and assigns, and no rights are intended to be, or are, created hereunder for the benefit of any third party.

Section 7.18. Time Is Of The Essence. Time is of the essence in interpreting and performing this Restated MAA.

Section 7.19. Statutory Collateral Requirement. Nothing in this Restated MAA shall be construed to permit a Bank to participate in issues of Debt Securities or other obligations if it does not satisfy the collateral requirements of Section 4.3(c) of the Act. For purposes of this Section, "Bank" shall include any System bank in conservatorship or receivership.

Section 7.20. Termination of System Status. Nothing in this Restated MAA shall be construed to preclude a Bank from terminating its status as a System institution pursuant to Section 7.10 of the Act, or from at that time withdrawing, as from that time forward, the funding resolution it has adopted pursuant to Section 4.4(b) of the Act. A Bank that terminates its System status shall cease to have any rights or obligations under this Restated MAA, except that it shall continue to be subject to Article VIII with respect to claims accruing through the date of such termination of System status.

Section 7.21. Restrictions Concerning Subsequent Litigation. It is expressly agreed by the Banks that (a) characterization or categorization of Banks, (b) information furnished to the Committee or other Banks, and (c) discussions or decisions of the Banks or Committee under this Restated MAA shall not be used in any subsequent litigation challenging FCA's or the Insurance Corporation's action or inaction.

Section 7.22. Effect of this Agreement. Neither this Restated MAA nor FCA approval hereof shall in any way restrict or qualify the authority of FCA or the Insurance Corporation to exercise any of the powers, rights, or duties granted by law to FCA or the Insurance Corporation.

Section 7.23. Relationship to the Joint and Several Liability Reallocation Agreement. This Restated MAA and the Joint and Several Liability Reallocation Agreement are separate agreements, and invalidation of one does not affect the other.

ARTICLE VIII - INDEMNIFICATION

Section 8.01. Definitions. As used in this Article VIII:

(a) "Indemnified Party" means any Bank, the Funding Corporation, the Committee, the Scorekeeper, or any of the past, present or future directors, officers, stockholders, employees or agents of the foregoing.

(b) "Damages" means any and all losses, costs, liabilities, damages and expenses, including, without limitation, court costs and reasonable fees and expenses of attorneys expended in investigation, settlement and defense (at the trial and appellate levels and otherwise), which are incurred by an Indemnified Party as a result of or in connection with a claim alleging liability to any non-Party for actions taken pursuant to or in connection with this Restated MAA. Except to the extent otherwise provided in this Article VIII, Damages shall be deemed to have been incurred by reason of a final settlement or the dismissal with prejudice of any such claim, or the issuance of a final nonappealable order by a court of competent jurisdiction which ultimately disposes of such a claim, whether favorably or unfavorably.

Section 8.02. Indemnity. To the extent consistent with governing law, the Banks, jointly and severally, shall indemnify and hold harmless each Indemnified Party against and in respect of Damages, provided, however, that an Indemnified Party shall not be entitled to indemnification under this Article VIII in connection with conduct of such Indemnified Party constituting gross negligence, willful misconduct, intentional tort or criminal act, or in connection with civil money penalties imposed by FCA. In addition, the Banks, jointly and severally, shall indemnify an Indemnified Party for all costs and expenses (including, without limitation, fees and expenses of attorneys) incurred reasonably and in good faith by an Indemnified Party in connection with the successful enforcement of rights under any provision of this Article VIII.

Section 8.03. Advancement of Expenses. The Banks, jointly and severally, shall advance to an Indemnified Party, as and when incurred by the Indemnified Party, all reasonable expenses, court costs and attorneys' fees incurred by such Indemnified Party in defending any proceeding involving a claim against such Indemnified Party based upon or alleging any matter that constitutes, or if sustained would constitute, a matter in respect of which indemnification is provided for in Section 8.02, so long as the Indemnified Party provides the Banks with a written undertaking to repay all amounts so advanced if it is ultimately determined by a court in a final nonappealable order or by agreement of the Banks and the Indemnified Party that the Indemnified Party is not entitled to be indemnified under Section 8.02.

Section 8.04. Assertion of Claim.

(a) Promptly after the receipt by an Indemnified Party of notice of the assertion of any claim or the commencement of any action against him, her or it in respect of which indemnity may be sought against the Banks hereunder (an "Assertion"), such Indemnified Party shall apprise the Banks, through a notice to each of them, of such Assertion. The failure to so notify the Banks shall not relieve the Banks of liability they may have to such Indemnified Party hereunder, except to the extent that failure to give such notice results in material prejudice to the Banks.

(b) Any Bank receiving a notice under paragraph (a) shall forward it to the Committee (which, if not in existence, shall be formed at the instance of such Bank to consider the matter). The Banks, through the Committee, shall be entitled to participate in, and to the extent the Banks, through the

Committee, elect in writing on thirty days' notice, to assume, the defense of an Assertion, at their own expense, with counsel chosen by them and satisfactory to the Indemnified Party. Notwithstanding that the Banks, through the Committee, shall have elected by such written notice to assume the defense of any Assertion, such Indemnified Party shall have the right to participate in the investigation and defense thereof, with separate counsel chosen by such Indemnified Party, but in such event the fees and expenses of such separate counsel shall be paid by such Indemnified Party and shall not be subject to indemnification by the Banks unless (i) the Banks, through the Committee, shall have agreed to pay such fees and expenses, (ii) the Banks shall have failed to assume the defense of such Assertion and to employ counsel satisfactory to such Indemnified Party, or (iii) in the reasonable judgment of such Indemnified Party, based upon advice of his, her or its counsel, a conflict of interest may exist between the Banks and such Indemnified Party with respect to such Assertion, in which case, if such Indemnified Party notifies the Banks, through the Committee, that such Indemnified Party elects to employ separate counsel at the Banks' expense, the Banks shall not have the right to assume the defense of such Assertion on behalf of such Indemnified Party. Notwithstanding anything to the contrary in this Article VIII, neither the Banks, through the Committee, nor the Indemnified Party shall settle or compromise any action or consent to the entering of any judgment (x) without the prior written consent of the other, which consent shall not be unreasonably withheld, and (y) without obtaining, as an unconditional term of such settlement, compromise or consent, the delivery by the claimant or plaintiff to such Indemnified Party of a duly executed written release of such Indemnified Party from all liability in respect of such Assertion, which release shall be satisfactory in form and substance to counsel to such Indemnified Party. The Funding Corporation shall not be entitled to vote on actions by the Committee under this paragraph (b) or Section 8.08.

Section 8.05. Remedies; Survival. The indemnification, rights and remedies provided to an Indemnified Party under this Article VIII shall be (i) in addition to and not in substitution for any other rights and remedies to which any of the Indemnified Parties may be entitled, under any other agreement with any other Person, or otherwise at law or in equity, and (ii) provided prior to and without regard to any other indemnification available to any Indemnified Party. This Article VIII shall survive the termination of this Restated MAA.

Section 8.06. No Rights in Third Parties. This Restated MAA shall not confer upon any Person other than the Indemnified Party any rights or remedies of any nature or kind whatsoever under or by reason of the indemnification provided for in this Article VIII.

Section 8.07. Subrogation; Insurance. Upon the payment by the Banks to an Indemnified Party of any amounts for which an Indemnified Party shall be entitled to indemnification under this Article VIII, if the Indemnified Party shall also have the right to recover such amount under any commercial insurance, the Banks shall be subrogated to such rights to the extent of the indemnification actually paid. Where coverage under such commercial insurance may exist, the Indemnified Party shall promptly file and diligently pursue a claim under said insurance. Any amounts paid pursuant to such claim shall be refunded to the Banks to the extent the Banks have provided indemnification payments under this Article VIII, provided, however, that recovery under such insurance shall not be deemed a condition precedent to the indemnification obligations of the Banks under this Article VIII.

Section 8.08. Sharing in Costs. The Banks shall share in the costs of any indemnification payment hereunder as the Committee shall determine.

ARTICLE IX - DEFINITIONS

The following definitions are used in this Restated MAA:

"Act" means the Farm Credit Act of 1971, 12 U.S.C. section 2001, et seq., as amended from time to time, or any successors thereto.

The "Additional Restrictions" are that a Bank (a) shall manage its asset/liability mix so as not to increase, and, to the extent possible, so as to reduce or eliminate, any Interest-Rate Sensitivity Deduction in its Net Composite Score, and (b) shall not increase the dollar amount of any liabilities, or take any action giving rise to a lien or pledge on its assets, senior to its liability on Debt Securities other than (i) tax liabilities and secured liabilities arising in the ordinary course of business through activities other than borrowing, such as mechanic's liens or judgment liens, and (ii) secured liabilities, or an action giving rise to such a lien or pledge, incurred in the ordinary course of business as the result of issuing secured debt or entering into repurchase agreements, provided, however, that such debt issuances and agreements may be undertaken to the extent that the proceeds therefrom are used to repay the principal of outstanding Debt Securities and the value of the collateral securing the debt issuances or the agreements (computed in the same manner as provided under Section 4.3(c) of the Act) does not exceed the amount of principal so repaid.

"Associations" means agricultural credit associations, federal land bank associations, federal land credit associations and production credit associations.

"Average Net Composite Score" is defined in Section 1.03.

"Bank" means a bank (including its consolidated subsidiaries) of the Farm Credit System, other than (except where noted) any bank in conservatorship or receivership (and its consolidated subsidiaries).

"Banks" means the banks (including their consolidated subsidiaries) of the Farm Credit System, other than (except where noted) any banks in conservatorship or receivership (and their consolidated subsidiaries).

"Business Day" means any day other than a Saturday, Sunday or Federal holiday.

"Business Plan" means the business plan required under 12 C.F.R. 618.8440, as amended from time to time, or any successors thereto.

"Category" means Category I, Category II, or Category III, as the circumstances require.

"Category I" is defined in Section 1.05.

"Category II" is defined in Section 1.06.

"Category II Interim Restrictions" means the requirements set forth in Section 4.02.

"Category III" is defined in Section 1.07.

"Category III Interim Restrictions" means the requirements set forth in Section 5.02.

"CIPA" means that certain Amended and Restated Contractual Interbank Performance Agreement among the Banks of the Farm Credit System and the Federal Farm Credit Banks Funding Corporation, the Scorekeeper, dated as of June 30, 2011, as amended from time to time, or any successor thereto.

"CIPA Oversight Body" is defined in Section 1.02.

"Collateral" is defined as in Section 4.3(c) of the Act and the regulations thereunder, as amended from time to time, or any successors thereto.

The "Committee" is defined in Section 2.01.

"Continued Access Decision(s)" means a decision, subject to the procedures, terms and conditions described in Article VI, that Final Restrictions or a Final Prohibition not go into effect, or be lifted.

"Continued Access Request" means a request for a Continued Access Decision.

"Days" means calendar days, unless the term Business Days is used.

"Debt Securities" means Systemwide and consolidated obligations issued through the Funding Corporation, within the meaning of Sections 4.2(c), 4.2(d) and 4.9 of the Act.

"Disclosure Program" means the program established, pursuant to resolutions of the Banks and the Funding Corporation adopted in 1987 and last substantively revised in 1994, for disclosure at the Systemwide level of financial and other information in connection with the issuance of Debt Securities, as amended from time to time, or any successor thereto.

"FCA" means the Farm Credit Administration.

"Final Prohibition" means the requirements set forth in Section 5.01.

"Final Restrictions" means the requirements set forth in Section 4.01.

"First Restated MAA" means that certain Amended and Restated Market Access Agreement, dated July 1, 2003, among the Banks and the Funding Corporation.

"Funding Corporation" means the Federal Farm Credit Banks Funding Corporation.

"Going Concern Qualification" means a qualification expressed pursuant to Statement of Auditing Standards No. 59, "The Auditor's Consideration of an Entity's Ability to Continue As a Going Concern."

"Insurance Corporation" means the Farm Credit System Insurance Corporation.

"Insurance Fund" means the Farm Credit Insurance Fund maintained by the Insurance Corporation pursuant to Section 5.60 of the Act.

"Interest-Rate Sensitivity Deduction" is defined as in Article II of CIPA, and the Model referred to therein, as amended from time to time, or any successor thereto.

"Joint and Several Liability Reallocation Agreement" means that certain Joint and Several Liability Reallocation Agreement among the Banks and the Funding Corporation.

"Liquidity Deficiency Deduction" is defined as in Article II of CIPA, and the Model referred to therein, as amended from time to time, or any successor thereto.

"Model" means the term Model as it is defined in the CIPA.

"Net Collateral" means a Bank's collateral as defined in 12 C.F.R. 615.5050, as amended from time to time, or any successors thereto (except that eligible investments as described in 12 C.F.R. 615.5140, as amended from time to time, or any successors thereto, are to be valued at their amortized cost), less an amount equal to that portion of the allocated investments of affiliated Associations that is not counted as permanent capital by the Bank.

"Net Collateral Ratio" means a Bank's Net Collateral divided by Bank-only total liabilities (i.e., the total liabilities used to compute the net collateral ratio defined in 12 C.F.R. 615.5301(d), as amended from time to time or any successors thereto).

"Net Composite Score" is defined in Section 1.03.

"100% Vote" means an affirmative vote, through each voting Bank’s board of directors or its designee, of all Banks that are entitled to vote on a matter.

"Original Agreement" means that certain Market Access Agreement, dated September 1, 1994 and effective as of November 23, 1994, among the Banks and the Funding Corporation.

"Parties" mean the parties to this Restated MAA. A bank in conservatorship or receivership is not a party to this Restated MAA.

"Permanent Capital" is defined as in Section 4.3A(a)(1) of the Act and the regulations thereunder, as amended from time to time, or any successors thereto.

"Permanent Capital Ratio" means a Bank's Permanent Capital as a percentage of its Risk-Adjusted Asset Base.

"Person" means any human being, partnership, association, joint venture, corporation, legal representative or trust, or any other entity.

"Ratio(s)" means either the Net Collateral Ratio, or Permanent Capital Ratio, as the circumstances require.

"Risk-Adjusted Asset Base" is defined as in 12 C.F.R. 615.5210(e), as amended from time to time, or any successor thereto.

"Scorekeeper" is defined in Section 1.01.

"System" means the Farm Credit System.

"System Disclosure Agent" means the Funding Corporation or such other disclosure agent as all Banks shall unanimously agree upon, to the extent permitted by law or regulation. For purposes of this definition, "Banks" shall include any System bank in conservatorship or receivership.

[end of Draft Second Amended and Restated MAA]

Date: October 27, 2011

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

[1] 68 FR 19539 (April 21, 2003).

[2] 75 FR 76729 (December 9, 2010).

[3] 12 U.S.C. 2155.

[4] 75 FR 64727 (October 20, 2010).

[5] CoBank, ACB and U.S. Agbank, FCB plan to merge as of January 1, 2012. The FCA has preliminarily approved the merger, and the boards and stockholders of both banks have voted to approve the merger.

75 FR 70619, 11/18/2010

Handbook Mailing HM-10-13

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Parts 612, 620, and 630

RIN 3052-AC41

Standards of Conduct and Referral of Known or Suspected Criminal Violations; Disclosure to Shareholders; and Disclosure to Investors in System-wide and Consolidated Bank Debt Obligations of the Farm Credit System; Compensation, Retirement Programs, and Related Benefits

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking (ANPRM).

SUMMARY: The Farm Credit Administration (FCA, we, or our) is requesting comments on ways to clarify or otherwise enhance our regulations related to Farm Credit System (System) institutions' disclosures to shareholders and investors on compensation, retirement programs and related benefits for senior officers, highly compensated individuals, and certain individual employees or other groups of employees. We are also seeking comments on whether we should issue new regulations in related areas. In keeping with today's financial and economic environment, we believe it prudent and timely to undertake a review of our regulatory guidance on the identified areas. We intend to consider the information and suggestions we receive in response to this ANPRM when developing a rulemaking on compensation disclosures and related areas.

DATES: You may send comments on or before March 18, 2011.

ADDRESSES: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comments multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Deborah A. Wilson, Senior Accountant, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434,

or

Laura McFarland, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objective

The objective of this ANPRM is to gather information for the development of a rulemaking that could result in:

- Enhancing the transparency and consistency of disclosures related to System institution compensation policies and practices[1] for senior officers,[2] highly compensated individuals,[3] and/or certain other groups of employees whose activities, either individually or in the aggregate, are reasonably likely to materially impact an institution's financial performance and risk profile;

- Clarifying and enhancing the authorities and responsibilities of System institution compensation committees[4] in furtherance of their oversight activities;

- Increasing user-control in System institutions' compensation policies and practices by providing for a non-binding shareholder vote on senior officer compensation;

- Requiring timely notice to interested parties of significant events, facts or circumstances occurring at a System institution between required reporting periods;

- Addressing the appropriateness of, and enhancing the disclosure of, certain payments to System institution directors; and

- Providing audit committees greater authority to access external resources when needed.

II. Background

The Farm Credit Act of 1971, as amended (Act),[5] authorizes the FCA to issue regulations implementing the provisions of the Act, including those provisions that address System institution disclosures to shareholders and investors. Our regulations are intended to ensure the safe and sound operations of System institutions and govern the disclosure of financial information to shareholders of, and investors in, the Farm Credit System.[6] Congress explained in section 514 of the Farm Credit Banks and Associations Safety and Soundness Act of 1992 (1992 Act)[7] that disclosure of financial information and the reporting of potential conflicts of interest by institution directors, officers, and employees help ensure the financial viability of the System. In the 1992 Act, Congress required that we review our regulations to ensure that System institutions provide adequate disclosures to shareholders and other interested parties. We completed this initial review in 1993 making appropriate amendments to our "Standards of Conduct" regulations (59 FR 24889, May 13, 1994), our "Disclosure to Shareholders" regulations (59 FR 37406, July 22, 1994), and our "Disclosure to Investors in System-wide and Consolidated Bank Debt Obligations of the Farm Credit System" regulations (59 FR 46742, September 12, 1994). We continue to periodically review and update our disclosure regulations to ensure they are appropriate for current business practices, that they ensure System institutions provide their shareholders with information to assist them in making informed decisions regarding the operations of the institutions, and that the disclosures provide investors with information necessary to assist them in making investment decisions.

In keeping with today's economic and business environments and in accordance with the findings of Congress under the 1992 Act, we believe it is prudent and timely to undertake a review of our regulatory guidance related to senior officer compensation. The recent turmoil within the financial industry and the ensuing decline in the economy highlight the need to ensure that shareholders and investors are informed of compensation policies and practices. Shareholders and investors need information that allows them to assess which policies and practices encourage excessive risk-taking at the expense of the institution's safety and soundness. With appropriate information, shareholders and investors can evaluate whether the institution's compensation policies and practices create an environment in which employees take imprudent risks in order to maximize their expected income at the expense of the institution's earnings performance and shareholder return. Similar efforts are in process at other regulatory agencies. For example, the Securities and Exchange Commission (SEC) recently revised its regulations to require that issuers disclose their compensation policies and practices as they relate to the company's risk management.[8] Likewise, the Board of Governors of the Federal Reserve System (FRB) has undertaken two supervisory initiatives involving a review of incentive compensation practices at certain banking organizations. The FRB has issued supervisory guidance designed to ensure that incentive compensation policies at banking organizations supervised by the FRB do not encourage imprudent risk-taking and are consistent with the safety and soundness of the organization.[9] Also, the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (Wall Street Reform Act)[10] includes amendments to the Securities Exchange Act of 1934 requiring, among other things, a separate resolution subject to a non-binding shareholder vote on the compensation of executive officers of a SEC issuer.[11] In addition, under the Wall Street Reform Act, each SEC issuer is required to disclose information that shows the relationship between executive compensation actually paid and the financial performance of the reporting entity.[12]

Active, effective oversight of senior officer compensation policies and practices will help align those policies and practices with safe and sound operations. Providing transparent, timely and accurate disclosures of senior officer compensation policies and practices will help ensure an institution adequately fulfills its obligation to its shareholders and investors.

III. Areas of Consideration

We are reviewing our regulations in order to identify where our disclosure regulations might be amended to enhance the transparency of an institution's compensation policies and practices and if those practices affect the safety, soundness and financial performance of the institution. Also, we are reviewing our regulations to determine if they should be amended to facilitate qualified, objective and active compensation committees that are tasked to oversee an institution's compensation programs. We are interested in public response to the questions contained in this ANPRM, including ways in which our regulations might further enhance disclosures of senior officer compensation policies and practices. We are also interested in the ways in which an institution's compensation committee might further engage in active and effective oversight of those policies and practices.

A. Enhanced Disclosures of Senior Officer Compensation

Our existing disclosure regulations at §§ 620.5(i) and 630.20(i) require that certain disclosures of compensation paid to, or earned by, senior officers and other highly compensated employees (hereinafter collectively referred to as "senior officers") be included in an institution's annual report to shareholders (or an association's annual meeting information statement). Our regulations also require disclosure of certain benefits paid to senior officers pursuant to a plan or arrangement in connection with resignation, retirement, or termination. However, depending on when an officer retires (or otherwise terminates employment with the institution), the payment may not be disclosed or it may not be disclosed in a timely manner due to the timing of the actual payment to the officer. As a result, shareholders and investors may not have all the information they need to make informed decisions on an institution's compensation policies and practices for senior officers.

We are considering whether current required disclosures should be changed to include quantitative and qualitative information on the obligations that have accrued to an institution from senior officers' supplemental retirement and deferred compensation plans. Also, we want to identify how the disclosures could provide greater clarity to the variable components of senior officers' compensation packages. We believe disclosures should provide information that assists shareholders and investors in understanding the impact of compensation programs on an institution's operations. Shareholders and investors require sufficient information to assess whether senior officers' compensation is appropriate in view of the institution's financial condition, risk profile, and business activities. This information enables shareholders to understand how an institution's board or compensation committee exercises its oversight responsibilities of ensuring a comprehensive and balanced compensation program that holds management accountable for an institution's financial performance.

Questions (1) through (8) of Section IV of this ANPRM address this topic.

B. Compensation Committees

Our existing rules at §§ 620.31 and 630.6(b) require that System institutions have compensation committees and that these committees be responsible for reviewing the compensation policies and plans for senior officers and employees, as well as approving the overall compensation program for senior officers. Compensation committee oversight is critical in ensuring compensation policies and practices do not jeopardize an institution's safety and soundness. In FCA bookletter, "Compensation Committees" (BL-060), dated July 9, 2009, we issued guidance on how compensation committees could fulfill these duties. We are considering incorporating this guidance into our existing rules. We are also considering additional ways to enhance the authorities and responsibilities of System institution compensation committees to continue to achieve active and effective oversight of senior officers' compensation policies and practices. For example, in order for compensation committees to effectively fulfill their role, they must be specifically tasked with ensuring that compensation policies and practices do not jeopardize the safety and soundness of the institution. We are considering ways to re-emphasize that oversight responsibility. Understanding the financial commitment and total cost to the institution of the compensation programs and verifying that the institution is providing accurate and transparent disclosures on compensation are appropriate tasks for a compensation committee.

We are aware that some System institutions engage compensation consultants to make recommendations on compensation programs, plans, policies and practices. Compensation consultants can provide significant expertise to the board or compensation committee on compensation matters. These same consultants may also provide additional services, such as administration of compensation and benefit programs or actuarial services, on behalf of an institution's management. The degree of reliance placed on the consultant's expertise by the compensation committee may be a function of the consultant's independence from management influence. Therefore, we are considering requiring disclosure of the additional services provided to management by the consultant and requiring that the related fees paid to the consultant be disclosed. We are also considering if the significance of these additional services should impact whether they are included in the compensation disclosures.

Questions (9) through (13) of Section IV of this ANPRM address this topic.

C. <u>Shareholder Approval of Senior Officers' Compensation</u>

Recent initiatives, such as the Wall Street Reform Act, require entities that are SEC issuers to include a separate resolution in their proxy solicitations subject to shareholder vote on the compensation of the entities' executives. We are considering whether the FCA should issue regulations requiring a separate, non-binding, advisory shareholder vote on senior officer compensation and, if so, what those regulations should require. By providing for a non-binding advisory vote, shareholders would have a process through which they could express their approval or disapproval of an institution's compensation policies and practices. Board oversight and governance of compensation policies and practices may be more effective and enhanced if the board is explicitly informed of shareholder approval or disapproval. A non-binding, advisory shareholder vote would not bind the board of directors or compensation committee to any particular course of action and would not overrule any board or committee decisions related to senior officers' compensation.

Submitting senior officer compensation to a non-binding, advisory shareholder vote may be a practice that is appropriate for institutions that are cooperatively structured. One of the core cooperative principles is that those who use the cooperative should also control it. Submitting senior officer compensation to an advisory vote by System institution shareholders may promote member participation in their institution.

Question (14) of Section IV of this ANPRM addresses this topic.

D. <u>Notice of Significant or Material Events</u>

The FCA promotes sound governance practices. In doing so, we believe interested parties deserve timely notice and disclosure of any event, fact or circumstance that boards and management consider material or significant to the operations or financial condition of their institution. The SEC requires its registrants to file, in a timely manner, a current report to announce major events that occur between reporting periods (i.e., the Form 8-K, Current Report). We are considering requiring System institutions to provide similar current reporting on intervening events that occur between annual and quarterly reporting periods. The intervening events we are considering include enforcement actions taken by or supervisory agreements with the FCA, departure of an institution's director or an officer, results of matters an institution may submit to a vote by its shareholders, and other similar events.

Question (15) of Section IV of this ANPRM addresses this topic.

E. Remuneration to Boards of Directors in Connection with Conclusion of Services

Section 612.2130(b) of our regulations defines a conflict of interest, or the appearance thereof. The rule states that a conflict exists, or may appear to exist, when a person has a financial interest in a transaction, relationship or activity that actually affects, or has the appearance of affecting, the person's ability to perform official duties and responsibilities in a totally impartial manner and in the best interest of the institution. Payments to a director in connection with a restructuring or downsizing of the board or as a result of a merger, consolidation or other form of institutional reorganization may result in a board member having, or appearing to have, a conflict of interest or lack of total independence related to the transaction or board action. Shareholders and boards have approved such payments for economic reasons or when they wanted to recognize the contributions of directors stepping down from the board. We are considering regulating payments to directors under certain circumstances and also considering how or if these payments should be disclosed.

Question (16) of Section IV of this ANPRM addresses this issue.

F. Audit Committees

Sections 620.30(c) and 630.6(a)(3) of the FCA's regulations require a two-thirds majority vote of the full board of directors of a bank, an association or the Federal Farm Credit Banks Funding Corporation (Funding Corporation) to deny its respective audit committee's request for resources. We are considering whether we should remove the ability of the full board to deny a request from its audit committee for external resources.[13] We are considering this matter based on a May 7, 2010, request from the Funding Corporation submitted on behalf of the System Audit Committee (SAC), asking us to amend § 630.6(a)(3) of our regulations to remove the authority of the board of directors of the Funding Corporation to deny the SAC certain resources.

Question (17) of Section IV of this ANPRM addresses this request.

IV. Request for Comments

We request and encourage any interested person(s) to submit comments on the following questions and ask that you support your comments with relevant data or examples. We remind commenters that comments, and data submitted in support of a comment, are available to the public through our rulemaking files.

(1) Should FCA enhance senior officer compensation disclosure requirements to improve transparency and current practices? Specifically, should the FCA consider enhancing disclosures on:

(a) The significant terms of senior officers' employment arrangements, whether or not dollar amounts are paid or earned during the reporting year, including components related to deferred compensation plans, supplemental retirement plans, performance agreements, and incentive or bonus compensation based on financial information; and

(b) The position titles of officers included in the aggregated group's compensation reported under existing § 620.5(i)(2)(i)(B) of our regulations?

(2) Should the FCA remove from § 620.5(i)(2) the option that allows associations to disclose senior officer compensation information in annual meeting information statements instead of disclosing it in annual reports?

(3) What additional disclosures (qualitative and quantitative) are needed to ensure that all compensation, including deferred compensation and supplemental retirement benefits, are fully disclosed in a timely manner and that an institution's total compensation policies, practices, and obligations for senior officers are effectively communicated in a transparent and timely manner?

(4) Should FCA require the disclosure of compensation policies and practices related to the activities of certain employees, other than senior officers, which, either individually or in the aggregate, may expose the institution to a material amount of adverse risk? If so, what disclosures are needed to ensure the compensation programs, practices, and incentives for such employees are adequately disclosed so that shareholders and investors are informed of the potential risk areas?

(5) To enhance transparency and a comprehensive understanding of the link between risk, return, and compensation incentives, should a discussion of an institution's overall risk and reward structure for senior officer compensation and benefit policies and practices be a required disclosure and, if so, what level of disclosure or qualitative information should be required?

(6) To ensure that all sources of compensation are disclosed, should institutions be required to disclose estimated payments to be made in the future to each senior officer in connection with deferred compensation arrangements, performance or incentive awards, and/or supplementary retirement benefits? If so, how should the disclosures be presented and for what periods? What other sources of senior officer compensation should be captured in current financial disclosures to shareholders?

(7) To ensure that shareholders and investors have an appropriate understanding of the assumptions used by the institution to determine estimated future payments for compensation or benefits, if disclosed, should the assumptions used to determine the future payments also be disclosed? If so, should the disclosure include why the assumptions used to determine the estimated payments are different from those used to determine the present value of dollar amounts disclosed in the Summary Compensation Table?

(8) Should institutions be required to disclose:

(a) The dollar amount of any tax reimbursements (such as Internal Revenue Code Section 280G tax gross-ups) provided by the institution to a senior officer;

(b) The business reason(s) for any material or significant change or adjustment to compensation or benefit programs from prior periods that increase or decrease salaries or compensation programs (individually or in the aggregate);

(c) Quantitative and qualitative benchmarks used to determine senior officer compensation and performance and incentive bonuses, if and why benchmarks used in the current reporting period were different from those used in prior periods, the business reason(s) for changing the benchmarks used, whether the individual officer was successful in attaining the requirements of the benchmark used, and if and how each benchmark relates to the financial performance of the institution;

(d) Significant events, trends or other information necessary to understand the institution's senior officer compensation policies and practices; and

(e) The vesting periods for long-term incentive and/or performance compensation or retirement benefits?

(9) To support the compensation committee's review and accountability processes, should compensation committees be required to certify compensation disclosures? If so, should the certification include a statement to the effect that:

(a) The compensation disclosures are true, accurate, and complete, and that the disclosures are in compliance with all applicable regulatory requirements;

(b) Comparable compensation practices used by the institution to develop its compensation policies support the valuation of senior officer compensation; and

(c) The institution's compensation policies and practices are consistent with the adverse risk-bearing capacity of the institution (as determined by the institution's board) and do not pose a threat to the safety and soundness of the institution?

(10) If compensation committees are required to certify compensation disclosures, what other areas should be addressed in the certification and what related statements should the committee certify?

(11) Would it strengthen the operation and independence of the compensation committee if the FCA required that at least one of the compensation committee members be an outside director (independent of any affiliation with the institution other than serving as a director)? What would be the benefits and/or concerns with such a requirement?

(12) If a System institution compensation committee uses the services of a compensation consultant, would the disclosure of that information be meaningful to shareholders and investors? What types of disclosures should be provided?

(13) If institution management engages the services of a compensation consultant that is also used by the compensation committee, or vice versa, should that fact be disclosed? If so, should the disclosure include a description of the additional services provided by the consultant for management that:

(a) Benefits the institution as a whole, and

(b) Are provided solely for management's benefit? Should the consultant's fees for the additional services be disclosed if those fees are in excess of de minimis amounts?

(14) To enhance transparency and shareholder understanding of compensation programs and practices, should FCA's regulations provide for a separate, non-binding advisory vote by System institution voting shareholders on senior officer compensation? If so:

(a) When and how should the vote occur;

(b) Within what timeframe should the results of the vote be reported to shareholders;

(c) Should certain System institutions be exempt from the voting requirement and, if so, what criteria should be used to exempt those institutions; and

(d) If a vote is required, should institutions be required to identify senior officer compensation amounts on an individual basis to facilitate the vote?[14]

(15) Should System institutions be required to issue current reports on events, facts, or circumstances that management considers material or significant to the operations or financial condition of a System institution, similar to the notice on changes in capital levels described in § 620.15?[15] If so, what form should the report take, what types of events should be reported, and what timeframe would be appropriate for its issuance?

(16) To ensure that certain payments to institution directors do not create the potential for a conflict of interest, or appearance thereof, should payments made to System institution directors in connection with a restructuring or downsizing of the board, or as a result of a merger, consolidation or other form of institutional reorganization be allowed or disallowed?

(a) Under what circumstances would such payments constitute a conflict of interest or an appearance thereof?

(b) If allowed, how and when should such payments be disclosed?

(17) Should FCA remove from §§ 620.30(c) and 630.6(a)(3) the ability of a board of directors to deny a request for resources from its audit committee?

Dated: November 12, 2010

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

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[1]12 CFR 620.5(i).

[2]All references to senior officer(s) in this ANPRM refer to a senior officer as defined in 12 CFR 619.9310.

[3]All references to highly compensated individuals in this ANPRM refer to those officers described in 12 CFR 620.5(i)(2)(i)(B).

[4]All references to compensation committees in this ANPRM refer to compensation committees as set forth in 12 CFR 620.31 and 12 CFR 630.6(b).

[5]Pub. L. 92-181, 85 Stat. 583, 12 U.S.C. 2001 et seq.

[6]Section 5.17(a)(8), (9) and (10) of the Act. 12 U.S.C. 2252(a)(8)(9) and (10).

[7]Pub. L. 102-552, 106 Stat. 4131.

[8]See SEC Release No. 33-9089, “Proxy Disclosure and Enhancements,” issued February 28, 2010.

[9]Board of Governors of the Federal Reserve System, Docket No. OP-1374, "Guidance on Sound Incentive Compensation Policies," June 21, 2010.

[10]Pub. L. 111-203, 124 Stat. 1376.

[11]See section 951 of Subtitle E of Title IX, "Investor Protections and Improvements to the Regulation of Securities," of the Wall Street Reform Act.

[12]See section 953 of Subtitle E of Title IX, "Investor Protections and Improvements to the Regulation of Securities," of the Wall Street Reform Act.

[13]External resources may include, but not be limited to, outside advisors, consultants, or legal counsel.

[14]12 CFR 620.5(i)(2)(i)(B) allows aggregated disclosure in the annual report of compensation paid to senior officers.

[15]12 CFR 620.15 provides for the notice to the FCA and shareholders by System banks and associations when an institution is not in compliance with the minimum permanent capital standards required by the FCA.

68 FR 23425, 05/02/2003

Handbook Mailing HM-03-10

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 613

RIN 3052-AC20

Eligibility and Scope of Financing

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Farm Credit Administration (FCA) is considering whether to revise its regulations governing eligibility and scope of financing for farmers, ranchers, and aquatic producers or harvesters who borrow from Farm Credit System (FCS or System) institutions that operate under titles I or II of the Farm Credit Act of 1971, as amended (Act). We are also considering whether we should modify our regulatory definition of "moderately priced" rural housing. We invite your comments.

DATES: You may send us comments by July 31, 2003.

ADDRESSES: You may send comments by electronic mail to "reg-comm@fca.gov," through the Pending Regulations section of FCA's Web site, "www.fca.gov," or through the government-wide " www.regulations.gov" portal. You may also send comments to Robert E. Donnelly, Acting Director, Regulation and Policy Division, Office of Policy and Analysis, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090 or by facsimile to (703) 734-5784. You may review copies of all comments we receive at our office in McLean, Virginia.

FOR FURTHER INFORMATION CONTACT:

Mark L. Johansen, Policy Analyst, Office of Policy and Analysis, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4498, TTY (703) 883-4434,

or

Richard Katz, Senior Attorney, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. <u>Introduction</u>

We received two petitions under 5 U.S.C. 553(e) to repeal § 613.3005, which limits the amount of credit that FCS institutions that operate under titles I or II of the Act can extend to eligible farmers, ranchers, and aquatic producers or harvesters (collectively referred to as "farmers"). The petitioners state that the Act does not restrict the System's authority to finance all the credit needs of any group of eligible farmers and, therefore, § 613.3005 should be eliminated as having no basis in law. The petitioners also state that § 613.3005 unnecessarily restricts the System's ability to serve creditworthy and eligible farmers, particularly those who have significant off-farm income, and young, beginning, and small farmers. One petitioner also asked us to change the definition of "moderately priced" rural housing in § 613.3030(a)(4). The petitioner stated that this definition has not kept pace with the evolving rural housing market and, therefore, is preventing FCS institutions that operate under titles I and II from fully serving the housing needs of eligible non-farm rural residents.

We have decided to start a rulemaking in response to these two petitions. We reserve judgment on the appropriate legal interpretation of the relevant provisions of the Act. Nevertheless, we believe it is appropriate to review our regulations governing eligibility and scope of financing for farmers and our definition of "moderately priced" rural housing. The goal of this rulemaking is to explore how our regulations can become more responsive to the needs of all eligible and creditworthy farmers and rural residents within the boundaries of the Act.

II. Background

A. Farmers

Section 1.9 of the Act authorizes FCS mortgage lenders to extend credit to "bona fide farmers, ranchers, or producers or harvesters of aquatic products." Section 1.11(a)(1) of the Act states that "Loans made by a Farm Credit [mortgage lender] to farmers, ranchers, and producers or harvesters of aquatic products may be for any agricultural or aquatic purpose and other credit needs of the applicant. . . ." Similarly, section 2.4(a)(1) authorizes certain FCS associations to "make, guarantee, or participate with other lenders in short- and intermediate-term loans and other similar financial assistance to . . . bona fide farmers and ranchers and the producers or harvesters of aquatic products, for agricultural or aquatic purposes and other requirements of such borrowers. . . ."

Under § 613.3000(a)(1), a "bona fide farmer or rancher" is "a person owning agricultural land or engaged in the production of agricultural products . . . ." The scope of financing regulation, § 613.3005, which the petitioners asked us to repeal, states:

> 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.

B. <u>Non-Farm Rural Housing</u>

Existing § 613.3030(a)(4) establishes two methods that FCS lenders may use to determine whether rural housing is "moderately priced." The first method derives from section 8.0(1)(B) of the Act, which defines "moderate priced" for the purpose of secondary market financing as dwellings (excluding the land) that do not exceed $100,000, as adjusted for inflation. The second method authorizes FCS banks and associations to determine whether housing in a particular rural area is "moderately priced" by documenting data from a credible, independent, and recognized national or regional source. Housing values at or below the 75th percentile are deemed to be moderately priced.

III. <u>Questions</u>

This rulemaking gives you the opportunity to tell us whether and how we should change our eligibility and scope of financing regulations for eligible farmers. We want to know if you think we should change the eligibility criteria for farmers as defined in § 613.3000. In addition, we seek your input on whether we should repeal, retain, or amend the scope of financing requirements in § 613.3005. We are particularly interested in your views on how we should regulate FCS lending for farmers' other credit needs. Please respond to the following questions.

1. Current § 613.3000(a)(1) defines a bona fide farmer, rancher, or aquatic producer as a person who either owns agricultural land or is engaging in the production of agricultural products. Do you think the FCA should retain or change this definition? If you favor changing this definition, please offer specific recommendations.

2. What limits, if any, should FCA regulations place on lending for farmers' other credit needs?

3. How should we regulate access to the other credit needs of eligible farmers who derive most of their income from off-farm sources? Do you favor retaining the current regulatory distinction between full-time and part-time farmers? If not, what would be a better approach?

4. Should we change our definition of "moderately priced" rural housing in § 613.3030(a)(4)? If you favor changing the definition, please offer specific recommendations.

The FCA welcomes other ideas or suggestions you may have about our eligibility and scope of financing regulations for eligible farmers and our regulations defining "moderately priced" rural housing.

The FCA also plans to conduct a public meeting on eligibility and scope of financing for eligible farmers and our definition of "moderately priced" rural housing. We will publish a separate notice in the Federal Register that will provide interested parties more information about the public meeting.

Dated: April 29, 2003

Jeanette C. Brinkley,
Secretary,
Farm Credit Administration Board.

68 FR 23426, 05/02/2003

Handbook Mailing HM-03-11

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 613

RIN 3052-AC20

Eligibility and Scope of Financing

AGENCY: Farm Credit Administration.

ACTION: Notice of public meeting.

SUMMARY: The Farm Credit Administration (FCA or agency) announces a public meeting to hear your views about whether and how we should revise our regulations governing eligibility and scope of financing for farmers, ranchers, and aquatic producers or harvesters who borrow from Farm Credit System institutions that operate under titles I or II of the Farm Credit Act of 1971, as amended (Act) and our definition of "moderately priced" rural housing.

DATES: The public meeting will be held on June 26, 2003, in McLean, Virginia, 22102-5090 (703) 883-4056.

ADDRESSES: The FCA will hold the public meeting at our headquarters location at 1501 Farm Credit Drive, McLean, Virginia at 9:00 a.m. Eastern Daylight Savings Time. You may submit requests to appear and present testimony for the public meeting by electronic mail to "reg-comm@fca.gov," through the Pending Regulations section of FCA's Web site, "www.fca.gov," or through the government-wide "www.regulations.gov" portal. You may also submit requests to Robert E. Donnelly, Acting Director, Regulation and Policy Division, Office of Policy and Analysis, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090 or by facsimile to (703) 734-5784.

FOR FURTHER INFORMATION CONTACT:

Mark L. Johansen, Policy Analyst, Office of Policy and Analysis, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4498, TTY (703) 883-4434,

or

Richard Katz, Senior Attorney, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Background

We started this rulemaking in response to two petitions that asked us to repeal the scope of financing regulations in § 613.3005. One petitioner also asked us to modify our definition of "moderately priced" rural housing in § 613.3030(a)(4). The goal of this rulemaking is to explore how our regulations can become more responsive to the needs of all eligible ranchers, and aquatic producers or harvesters (collectively referred to as "farmers") and non-farm rural residents within the boundaries of the Act. We are publishing an Advance Notice of Proposed Rulemaking (ANPRM) in this issue of the Federal Register. In this document, we are announcing that we will hold a public meeting so you have another forum to present your views to us.

II. Topics

At the hearing, we will ask that you answer the same questions we asked in the ANPRM:

1. Current § 613.3000(a)(1) defines a bona fide farmer, rancher, or aquatic producer as a person who either owns agricultural land, or is engaging in the production of agricultural products. Do you think the FCA should retain or change this definition? If you favor changing this definition, please offer specific recommendations.

2. What limits, if any, should FCA regulations place on lending for farmers' other credit needs?

3. How should we regulate access to the other credit needs of eligible farmers who derive most of their income from off-farm sources? Do you favor retaining the current regulatory distinction between full-time and part-time farmers? If not, what would be a better approach?

4. Should we change our definition of "moderately priced" rural housing in § 613.3030(a)(4)? If you favor changing the definition, please offer specific recommendations.

III. Request To Present Testimony

Anyone wishing to present testimony in person may notify us by June 21, 2003, or register to speak on the day of the meeting. A request to speak should provide the name, address, and telephone number of the person wishing to testify and the general nature of the testimony. Requests to provide testimony in person will be honored in order of receipt.

Parties who register to speak on the day of the meeting may be invited to provide their testimony if time permits. If more people wish to testify than time permits, we will accept written statements for the record for 30 calendar days following the date of the public meeting.
Please limit oral testimony at the meeting to 10 minutes per person and allow 5 minutes for follow-up questions. At the public meeting, we will also accept, for the record, written comments on questions and issues raised in the ANPRM or any other comments that attendees may have on the subject of eligibility and scope of financing for farmers, ranchers, and aquatic producers and harvesters and the definition of "moderately priced" rural housing.
You may also wish to submit written statements or detailed summaries of the text of your testimony. Written comments that you wish to submit to supplement your testimony should be presented to us by the close of the public meeting.

Written copies of the testimony, along with a recorded transcript of the proceedings, will be included in our official public record. A transcript of the public meeting and any written statements submitted to the agency will be available for public inspection at our office in McLean, Virginia.

IV. Special Accommodations

The meeting is accessible to people with disabilities. Requests for sign language interpretation or other auxiliary aids should be received by FCA's Office of Communications and Public Affairs at (703) 883-4056, (TTY (703) 883-4056) by June 21, 2003.

Dated: April 29, 2003

Jeanette C. Brinkley,
Secretary,
Farm Credit Administration Board.

68 FR 44490, 07/29/2003

Handbook Mailing HM-03-15

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 613

RIN 3052-AC20

Eligibility and Scope of Financing

AGENCY: Farm Credit Administration.

ACTION: Proposed rule; extension of comment period.

SUMMARY: The Farm Credit Administration (FCA) is extending the comment period on our Advance Notice of Proposed Rulemaking concerning eligibility and scope of financing for farmers, ranchers, and aquatic producers or harvesters, and "moderately priced" rural housing. We are extending the comment period so all interested parties have more time to respond to our questions.

DATES: Please send your comments to the FCA by October 29, 2003.

ADDRESSES: We encourage you to send comments by electronic mail to "reg-comm@fca.gov," through the Pending Regulations section of FCA's Web site, " www.fca.gov," or through the government-wide "www.regulations.gov" portal. You may also send comments to S. Robert Coleman, Director, Regulation and Policy Division, Office of Policy and Analysis, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090 or by facsimile to (703) 734-5784. You may review copies of all comments we receive at our office in McLean, Virginia.

FOR FURTHER INFORMATION CONTACT:

Mark L. Johansen, Policy Analyst, Office of Policy and Analysis, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4498, TTY (703) 883-4434.

Or

Richard A. Katz, Senior Attorney, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION: On May 2, 2003, FCA published a notice in the *Federal Register* seeking public comment on whether it should revise its regulations governing eligibility and scope of financing for farmers, ranchers, and aquatic producers or harvesters who borrow from Farm Credit System institutions that operate under titles I or II of the Farm Credit Act of 1971, as amended. In addition, we requested public comment on whether we should modify our regulatory definition of "moderately priced" rural housing. The comment period expires on July 31, 2003. *See* 68 FR 23425, May 2, 2003.

We also held a public meeting on June 26, 2003, to hear views from the public about whether and how we should revise our regulations governing eligibility, scope of financing, and "moderately priced" rural housing. After the public meeting two members of the public requested that we extend the comment period for an additional 90 days. In response to this request, we are extending the comment period until October 29, 2003, so all interested parties have more time to respond to our questions. The FCA supports public involvement and participation in its regulatory and policy process and invites all interested parties to review and provide comments on our notice.

Dated: July 23, 2003

Jeanette C. Brinkley,
Secretary,
Farm Credit Administration Board.

73 FR 15259, 03/21/2008

Handbook Mailing HM-08-2

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket ID OCC-2008-0002]

FEDERAL RESERVE SYSTEM

[Docket No. OP-1311]

FEDERAL DEPOSIT INSURANCE CORPORATION

RIN 3064-ZA00

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[Docket ID OTS-2008-0001]

FARM CREDIT ADMINISTRATION

RIN 3052-AC46

NATIONAL CREDIT UNION ADMINISTRATION

RIN 3133-AD41

Loans in Areas Having Special Flood Hazards; Interagency Questions and Answers Regarding Flood Insurance

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); Farm Credit Administration (FCA); National Credit Union Administration (NCUA).

ACTION: Notice and request for comment.

SUMMARY: The OCC, Board, FDIC, OTS, FCA, and NCUA (collectively, the Agencies) are soliciting comment on proposed revisions to the Interagency Questions and Answers Regarding Flood Insurance (Interagency Questions and Answers).

To help financial institutions meet their responsibilities under Federal flood insurance legislation and to increase public understanding of their flood insurance regulations, the staffs of the Agencies have prepared proposed new and revised guidance addressing the most frequently asked questions and answers about flood insurance. The proposed revised Interagency Questions and Answers contain staff guidance for agency personnel, financial institutions, and the public.

DATE: Comments must be submitted on or before May 20, 2008.

ADDRESSES:

OCC:

Because paper mail in the Washington, DC area and at the Agencies is subject to delay, commenters are encouraged to submit comments by e-mail, if possible. Please use the title ``Loans in Areas Having Special Flood Hazards; Interagency Questions and Answers
Regarding Flood Insurance'' to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- *E-mail:* regs.comments@occ.treas.gov.
- *Mail:* Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 1-5, Washington, DC 20219.
- *Fax:* (202) 874-4448.
- *Hand Delivery/Courier:* 250 E Street, SW., Attn: Public Information Room, Mail Stop 1-5, Washington, DC 20219.

Instructions: You must include ``OCC'' as the agency name and ``Docket ID OCC-2008-0002'' in your comment. Comments received,
including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any
information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this notice by any of the following methods:

- *Viewing Comments Personally:* You may personally inspect and photocopy comments at the OCC's Public Information Room, 250 E
  Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874-5043. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.
- *Docket:* You may also view or request available background documents and project summaries using the methods described above.

Board:

You may submit comments, identified by Docket No. OP-1311, by any of the following methods:

- *Agency Web Site:* http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.federalreserve.gov. Follow the instructions for submitting comments at http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://

www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.

- *Federal eRulemaking Portal:* http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.regulations.gov. Follow the instructions for submitting comments.
- *E-mail:* regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- *Fax:* (202) 452-3819 or (202) 452-3102.
- *Mail:* Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue,
NW., Washington, DC 20551.

All public comments are available from the Board's Web site at http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information.

Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.)
between 9 a.m. and 5 p.m. on weekdays.

FDIC:

You may submit comments, identified by RIN number 3064-ZA00 by any of the following methods:

- *Agency Web site:* http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.fdic.gov/regulations/laws/federal/propose.html. Follow instructions for submitting comments on the Agency Web Site.
- *E-mail:* Comments@FDIC.gov. Include the RIN number in the subject line of the message.
- *Mail:* Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW.,
Washington, DC 20429.
- *Hand Delivery/Courier:* Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between
- 7 a.m. and 5 p.m.

Instructions: All submissions received must include the agency name and RIN number. All comments received will be posted without change to http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.fdic.gov/regulations/laws/federal/propose.html including any personal information provided.

OTS:

You may submit comments, identified by OTS-2007-0001, by any of the following methods:

- *E-mail:* regs.comments@ots.treas.gov. Please include ID OTS-2008-0001 in the subject line of the message and include your name and telephone number in the message.
- *Fax:* (202) 906-6518.
- *Mail:* Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552,

- Attention: OTS-2008-0001.
- *Hand Delivery/Courier:* Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days, Attention:
  Regulation [[**Page** 15260]] Comments, Chief Counsel's Office, Attention: OTS-2008-0001.

Instructions: All submissions received must include the agency name and docket number for this rulemaking. All comments received will be entered into the docket and posted on Regulations.gov without change, including any personal information provided. Comments, including attachments and other supporting materials received are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

- *Viewing Comments Electronically:* OTS will post comments on the OTS Internet Site at http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1.
- *Viewing Comments On-Site* : You may inspect comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an
  appointment for access, call (202) 906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906-6518. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10 a.m. and 4 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

FCA:

We offer a variety of methods for you to submit comments. For accuracy and efficiency reasons, we encourage commenters to submit
comments by e-mail or through the Agency's Web site or the Federal eRulemaking Portal. You may also send comments by mail or by facsimile
transmission. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit
comments by any of the following methods:

- *E-mail:* Send us an e-mail at regcomm@fca.gov.
- *Agency Web Site:* http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.fca.gov. Once you are at the Web site, select ``Legal Info,'' then ``Pending Regulations and Notices.''
- *Federal eRulemaking Portal:* http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.regulations.gov. Follow the instructions for submitting comments.
- *Mail:* Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive,
- McLean, VA 22102-5090.
- *Fax:* (703) 883-4477. Posting and processing of faxes may be delayed. Please consider another means to comment, if possible.

You may review copies of comments we receive at our office in McLean, Virginia, or from our Web site at
http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://ww

w.fca.gov. Once you are in the Web site, select ``Legal Info,'' and then select ``Public Comments.'' We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

NCUA:

You may submit comments by any of the following methods (Please send comments by one method only):

- *Federal eRulemaking Portal:* http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.regulations.gov. Follow the instructions for submitting comments,
- *NCUA Web Site:* http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html. Follow the instructions for submitting comments.
- *E-mail* : Address to regcomments@ncua.gov. Include ``[Your name] Comments on Flood Insurance, Interagency Questions & Answers'' in the e-mail subject line.
- *Fax:* (703) 518-6319. Use the subject line described above for e-mail.
- *Mail:* Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.
- *Hand Delivery/Courier:* Same as mail address.

Public Inspection: All public comments are available on the agency's Web site at http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.ncua.gov/RegulationsOpinionsLaws/comments as submitted, except as may not be possible for technical reasons. Public comments will not be edited to remove any identifying or contact information. Paper copies of comments may be inspected in NCUA's law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment weekdays between 9 a.m. and 3 p.m. To make an appointment, call (703) 518-6546 or send an e-mail to OGCMail@ncua.gov.

FOR FURTHER INFORMATION CONTACT:

OCC: Pamela Mount, National Bank Examiner, Compliance Policy, (202) 874-4428; or Margaret Hesse, Special Counsel, Community and Consumer Law Division, (202) 874-5750, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

Board: Vivian Wong, Senior Attorney, Division of Consumer and Community Affairs, (202) 452-2412; Anjanette Kichline, Senior Supervisory Consumer Financial Services Analyst, (202) 785-6054; or Brad Fleetwood, Senior Counsel, Legal Division, (202) 452-3721, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. For the deaf, hard of hearing, and speech impaired only, teletypewriter (TTY), (202) 263-4869.

FDIC: Mira N. Marshall, Senior Policy Analyst (Compliance), Division of Supervision and Consumer Protection, (202) 898-3912; or Mark Mellon, Counsel, Legal Division, (202) 898-3884, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429. For the hearing impaired only, telecommunications device for the deaf (TDD): 800-925-4618.

OTS: Ekita Mitchell, Consumer Regulations Analyst, (202) 906-6451; Glenn Gimble, Senior Project Manager, (202) 906-7158; or Richard S. Bennett, Senior Compliance Counsel, (202) 906-7409, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

FCA: Mark L. Johansen, Senior Policy Analyst, Office of Regulatory Policy, (703) 993-4498; or Mary Alice Donner, Attorney Advisor, Office of General Counsel, (703) 883-4033, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090. For the hearing impaired only, TDD: (703) 883-4444.

NCUA: Moisette I. Green, Staff Attorney, Office of General Counsel, (703) 518-6540, National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314-3428.

SUPPLEMENTARY INFORMATION:

Background

The National Flood Insurance Reform Act of 1994 (the Reform Act) (Title V of the Riegle Community Development and Regulatory Improvement Act of 1994) comprehensively revised the two federal flood insurance statutes, the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973. The Reform Act required the OCC, Board, FDIC, OTS, and NCUA to revise their flood insurance regulations and required the FCA to promulgate flood insurance regulations for the first time. The OCC, Board, FDIC, OTS, NCUA, and FCA (collectively, ``the Agencies'') fulfilled these requirements by issuing a joint final rule in the summer of 1996. See 61 FR 45684 (August 29, 1996).

In connection with the 1996 joint rulemaking process, the Agencies received a number of requests to clarify specific issues covering a wide spectrum of the proposed rule's provisions. Many of these requests were addressed in the preamble to the joint final rule. The Agencies concluded, however, that given the number, level of detail, and diversity of subject matter of [[**Page** 15261]] the requests for additional information, guidance addressing the more technical compliance issues would be helpful and appropriate. Consequently, the Agencies decided to issue guidance to address these technical issues subsequent to the promulgation of the final rule (61 FR at 45685-86). That objective was fulfilled by the initial release of the Interagency Questions and Answers in 1997 (1997 Interagency Questions and Answers) by the Federal Financial Institution Examination Council (FFIEC). 62 FR 39523 (July 23, 1997).

In response to issues that have been brought to the attention of the Agencies in coordination with the Federal Emergency Management Agency (FEMA), the Agencies are releasing for public comment proposed revisions to the 1997 Interagency Questions and Answers.\1\ Among the changes the Agencies are proposing are the introduction of new questions and answers in a number of areas, including second lien mortgages, the imposition of civil money penalties, and loan syndications/participations. The Agencies are also proposing substantive modifications to questions and answers previously adopted in the 1997 Interagency Questions and Answers pertaining to construction loans and condominiums. Finally, the Agencies are proposing to revise and reorganize certain of the existing questions and answers to clarify areas of potential misunderstanding and to

provide clearer guidance to users. It is the intention of the Agencies that after public comment has been received and considered, and the
Interagency Questions and Answers have been adopted in final form, they will supersede the 1997 Interagency Questions and Answers and
supplement other guidance or interpretations issued by the Agencies and FEMA.

\1\ The proposed Interagency Questions and Answers have been prepared by staff from the OCC, Board, FDIC, OTS, NCUA and FCA in
consultation with and with the assistance of the FFIEC pursuant to 12 U.S.C. 3305(g).

For ease of reference, the following terms are used throughout this document: ``Act'' refers to the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973, as revised by the National Flood Insurance Reform Act of 1994 (codified at 42 U.S.C. 4001 et seq.). ``Regulation'' refers to each agency's current final rule.\2\

\2\ The Agencies' rules are codified at 2 CFR part 22 (OCC), 12 CFR part 208 (Board), 12 CFR part 339 (FDIC), 12 CFR part 572 (OTS),
12 CFR part 614 (FCA), and 12 CFR part 760 (NCUA).

Section-by-Section Analysis

Section I. Determining When Certain Loans Are Designated Loans for Which Flood Insurance Is Required Under the Act and Regulation

The Agencies propose to eliminate current section I entitled ``Definitions'' and replace it with new proposed section I to address more specific circumstances a lender may encounter when deciding whether a loan should be a designated loan for purposes of flood insurance. The Agencies are proposing to move the questions and answers currently in section I into subsequent sections for better organization. Meanwhile, questions and answers currently in other sections of the 1997 Interagency Questions and Answers that deal with determining when a loan is a designated loan under the Act and Regulation would be included in new section I.

Specifically, proposed question 1, which covers the applicability of the Regulation to a loan in a nonparticipating community, would be moved from current question 1 of section II. Further, the Agencies propose to move current question 2 of section II, discussing whether a loan is a designated loan when a lender purchases a whole loan, to question 3 of new section I. Current question 9 of section I, discussing whether a loan is a designated loan when a lender restructures a loan, would be moved to question 4 of this new section I, and proposed question 5, which addresses table funded loans, would be moved from question 3 of current section II. In addition, minor nonsubstantive changes have been made to these moved questions and answers to provide additional clarity.

The Agencies are also proposing to add two new questions and answers to this section in response to questions the Agencies have received from lenders. Proposed new question 2 explains that, upon a FEMA map change that results in a building or mobile home securing a loan being removed from a special flood hazard area (SFHA), the lender no longer must require mandatory flood insurance; however, the lender may choose to continue to require flood insurance for risk management purposes.

Proposed new question 6 explains that portfolio reviews of existing loans are not required by the Act or Regulation; however, sound risk management practices may lead a lender to conduct periodic reviews. These two new questions and answers are based on current guidance the Agencies have provided to lenders.

Section II. Determining the Appropriate Amount of Flood Insurance Required Under the Act and Regulation

Proposed section II would provide guidance on how lenders should determine the appropriate amount of flood insurance to require the borrower to purchase. The Agencies are proposing to retain existing questions 5 and 7 of section II in new section II and renumbering them as proposed questions 12 and 11, respectively. Although minor changes have been made to these two questions and answers for purposes of clarity, the changes are not substantive. Furthermore, part of the guidance currently provided in existing question 7 would be moved to proposed question 22 in section V, as discussed below.

Proposed new question 7 would discuss what is meant by the ``maximum limit of coverage available for the particular type of property under the Act." This concept is important because the Regulation states that the amount of flood insurance required ``must be at least equal to the lesser of the outstanding principal balance of the designated loan or the maximum limit of coverage available for the particular type of property under the Act." Proposed question 7 would introduce and define the insurance term, ``insurable value," as it relates to the determination of the maximum limit of coverage available under the Act. Proposed question 7 would also introduce the terms, ``residential building" and ``nonresidential building." These terms would be more fully defined in proposed new questions 8 and 9 of this section, respectively.

Proposed new question 10 would discuss how much flood insurance is required on a building located in an SFHA in a participating community. It would also provide an example showing how to calculate the amount of required flood insurance on a nonresidential building.

Proposed new question 13 would clarify that a lender can require more flood insurance than the minimum required by the Regulation. The Regulation requires a minimum amount of flood insurance; however, lenders may require more coverage, if appropriate.

Proposed new question 14 would address lender considerations regarding the amount of the deductible on a flood insurance policy purchased by a borrower. Generally, the guidance advises a lender to determine the reasonableness of the deductible on a case-by-case basis, taking into account [[**Page** 15262]] the risk that such a deductible would pose to the borrower and lender.

Section III. Exemptions from the mandatory flood insurance requirements

As with current section III, proposed section III would contain only one question and answer, which describes the statutory exemptions from the mandatory flood insurance requirements. Proposed question and answer 15 under section III would be revised to provide greater clarity, with no intended change in substance or meaning.

Section IV. Flood insurance requirements for construction loans

The Agencies are proposing a series of new and revised questions and answers to clarify the requirements regarding the mandatory purchase of flood insurance for construction loans to erect buildings that will be located in an SFHA. The Agencies believe that these questions and answers are necessary in light of recent concerns raised by some regulated lenders regarding borrowers' difficulties in obtaining flood insurance for construction loans at the time of loan origination.

Existing question 2 in section I would be revised to provide greater clarity and would be moved to proposed question 16 under proposed section IV. The proposed answer to question 16 would revise the existing guidance to limit its scope and explain that a loan secured by raw land located in an SFHA is not a designated loan that would require flood insurance coverage. The remaining guidance currently in the answer to existing question 2 in section I would be discussed in subsequent questions and answers in section IV in the proposed document, as detailed below.

Proposed question 17, derived from current question 1 in section I, would address whether a loan secured or to be secured by a building in the course of construction that is located or to be located in an SFHA in which flood insurance is available under the Act is a designated loan. The answer would provide that a lender must make a flood determination prior to loan origination for a construction loan. If the flood determination shows that the building securing the loan will be located in an SFHA, the lender must provide notice to the borrower, and must comply with the mandatory purchase requirements. Proposed question 18 would explain that, generally, a building in the course of construction is eligible for coverage under a National Flood Insurance Program (NFIP) policy, and that coverage may be purchased prior to the start of construction.

Proposed question 19 would address the timing of when flood insurance must be purchased for buildings under the course of construction. The Act and Regulation provide that lenders may not make, increase, extend, or renew any loan secured by improved real estate or a mobile home that is located or to be located in an SFHA unless the building is covered by adequate flood insurance. One way for lenders to comply with the mandatory purchase requirement for a loan secured by a building in the course of construction that is located in an SFHA is to require borrowers to have a flood insurance policy in place at the time of loan origination.

Recently, lenders have informed agency staff, however, that borrowers have been encountering difficulties in obtaining flood insurance for construction loans at the time of loan origination due to insurers' refusals to write policies on undeveloped land until either an elevation certificate has been issued for the structure or at least two walls and a roof for the building have been erected. The Agencies have also received reports that borrowers who are able to obtain flood insurance for construction loans at loan origination often pay the highest premiums possible because elevations for the insured property have not yet been established.

To address these concerns, the Agencies, in the answer to proposed question 19, would provide lenders with flexibility regarding the timing of the mandatory purchase requirement for construction loans by permitting lenders to allow borrowers to defer the purchase of flood insurance until a foundation slab has been poured and/or an elevation certificate has been issued. Lenders, however, must require the borrower to have flood insurance in place before funds are disbursed to pay for building construction on the property securing the loan (except as necessary to pour the slab or perform preliminary site work). A lender who elects this approach and does not require flood insurance at loan origination must have adequate internal controls in place to ensure compliance.

The Agencies also propose to add new question 20 to clarify whether the 30-day waiting period for an NFIP policy applies when the purchase
of flood insurance is deferred in connection with a construction loan since there has been confusion among lenders on this issue in the past.
Per guidance from FEMA, the answer would provide that the 30-day waiting period would not apply in such cases.\3\ The NFIP would rely on
the insurance agent's representation that the exception applies unless a loss has occurred during the first 30 days of the policy period.

\3\ FEMA, Mandatory Purchase of Flood Insurance Guidelines, (September 2007) at 30. FEMA has made available a new version of
this booklet electronically at
http://frwebgate.access.gpo.gov/cgi-bin/leaving.cgi?from=leavingFR.html&log=linklog&to=http://www.fema.gov/library/viewRecord.do?id=2954. Hard copies are available by calling FEMA's Publication Warehouse at (800) 480-2520.

Section V. Flood insurance requirements for agricultural buildings

The Agencies are proposing a new section V to address the flood insurance requirements for agricultural buildings that are taken as security for a loan, but that have limited utility to a farming operation. The section would also address loans secured by multiple buildings where some buildings are located in a flood hazard area and some buildings are not.

The proposed answer to new question 21 would explain that all buildings taken as security for a loan and located in an SFHA require flood insurance. Lenders have the option of carving a building from the security for a loan; however, the Agencies believe that it is typically
inappropriate for credit risk management reasons to do so.

The guidance in current question 7 under section II would be split between question 11 under proposed section II, as discussed above, and
question 22 under proposed section V. The proposed answer to question 22 would explain that a lender is always required to determine whether
a building securing a loan is located in an SFHA, but that only those buildings located in an SFHA and within a participating community are
required to have flood insurance. Flood insurance need not be required on those properties that (1) are not located in a special flood hazard
area (whether or not within a participating community) or (2) are located in a special flood hazard area that is not within a participating community.

Section VI. Flood insurance requirements for residential condominiums

For organizational purposes, the Agencies are proposing to consolidate questions and answers relating to the Regulation's flood insurance requirements for residential condominiums into a new section VI. In addition to modifying and expanding the two existing questions in the 1997 Interagency Questions and Answers on residential condominiums, the Agencies are proposing to add five additional [[**Page** 15263]] questions and answers to provide better clarity on the requirements.

Proposed question and answer 24 would modify and expand current question 8 under section II to more completely address the Regulation's flood insurance requirements for residential condominium units. The proposed answer would first explain that the amount of flood insurance coverage on the condominium unit required by the Regulation is the lesser of the outstanding principal balance of the loan or the maximum amount of coverage available under the NFIP.

The proposed answer would then explain that if the outstanding principal balance of the loan is greater than the maximum amount of coverage available under the NFIP, the lender must require a borrower whose loan is secured by a residential condominium unit to either:

- Ensure the condominium owners association has purchased an NFIP Residential Condominium Building Association Policy (RCBAP) covering either 100 percent of the insurable value (replacement cost) of the building, including amounts to repair or replace the foundation and its supporting structures, or an amount equal to the total number of units in the condominium building times $250,000, whichever is less; or

- Obtain an individual unit owner's dwelling policy in an amount sufficient to meet the Regulation's flood insurance requirements, if there is no RCBAP or the RCBAP coverage is less than either 100 percent of the insurable value (replacement cost) of the building or the amount equal to the total number of units in the condominium building times $250,000, whichever is less.

The proposed answer revises and clarifies the current answer to question 8 under section II. The current answer provides that ``to meet federal flood insurance requirements, an RCBAP should be purchased in an amount of at least 80 percent of the replacement value of the building or the maximum amount available under the NFIP (currently $250,000 multiplied by the number of units), whichever is less.''

The proposed question and answer recognizes that neither the Act nor the Regulation addresses explicitly the appropriate level of RCBAP coverage; rather, they address the general purchase requirement applicable to all types of buildings and mobile homes: The lesser of the outstanding principal balance of the loan or the maximum amount of insurance available under the NFIP. The proposed question and answer acknowledges the standard set forth in the Regulation, and clarifies that the maximum amount of insurance available under the NFIP for a residential condominium unit is the lesser of the maximum limit available for a residential condominium unit (currently, $250,000) or the insurable value of the unit (the replacement value of the building divided by the number of units).\4\ The proposed question and answer would also reflect that where the outstanding principal balance of the loan is greater than the maximum amount of coverage available under the NFIP, an RCBAP written at 80 percent of the replacement cost value of the building does not meet the Regulation's flood insurance requirements (unless that amount were equal to the maximum amount of insurance available under the NFIP, which is $250,000 multiplied by the number of units), whereas the current answer suggested that such a coverage level was adequate. While

FEMA's recent guidance prescribes 80 percent replacement cost value coverage as the minimum amount necessary to avoid imposition of a co-insurance penalty at the time of loss,\5\ proposed answer 24 clarifies that this amount of insurance is insufficient to comply with the Act's and Regulation's minimum requirements. The proposed answer would provide that where the outstanding principal balance of the loan is greater than the maximum amount of coverage available under the NFIP and the RCBAP is written at less than 100 percent of the insurable value (replacement cost) of the building or an amount equal to $250,000 multiplied by the number of units, whichever is less, the lender must require the borrower to obtain an individual unit owner's dwelling policy to meet the Regulation's flood insurance requirements.

\4\ In recent guidance, FEMA expressly discusses the statutory standard for determining the required amount of flood insurance for a condominium. FEMA Mandatory Purchase of Flood Insurance Guidelines, at 46.

\5\ FEMA's recent guidance encourages condominium associations to obtain 100 percent coverage. Id. at 47.

The Agencies are proposing the modification contained in proposed question 24 and its answer to be in accordance with the general mandatory purchase requirement in the Regulation. As FEMA has noted:

> Although unit owners have a shared interest in the common areas of the condominium building, as well as in their own unit, unit owners are unable to individually protect such common areas. Therefore, the RCBAP, insured to its full replacement cost value (RCV) to the extent possible under the NFIP, is the correct way to insure a residential condominium building against flood loss. A properly placed RCBAP protects the financial interests of the association, unit owners, and lenders and also satisfies the statutory requirements.\6\

\6\ See id. at 46.

The Agencies plan that any guidance adopted as final in question and answer 24 would apply to any loan that is made, increased, extended, or renewed after the effective date of the revised guidance. The Agencies further plan that the revised guidance would apply to any loan made prior to the effective date of the revised guidance, which a lender determines to be covered by flood insurance in an amount less than required by the Regulation, as set forth in proposed question and answer 24, at the first flood insurance policy renewal period following the effective date of the revised guidance.

Proposed question 27 would modify and expand current question 9 under section II to address lenders' options when a loan secured by a residential condominium unit is in a multi-unit complex whose condominium association allows its existing flood insurance policy to lapse. Specifically, if the borrower/unit owner or the condominium association fails to purchase adequate flood insurance within 45 days of the lender's notification of inadequate insurance coverage, the lender must force place flood insurance to cover the unit owner's dwelling in an amount adequate to meet the Regulation's flood insurance requirements.

The Agencies are also proposing five new questions and answers to address additional issues regarding flood insurance requirements for
residential condominiums. Proposed new question 23 would be added to specifically affirm that the mandatory flood insurance purchase
requirements under the Act and Regulation apply to loans secured by individual residential condominium units, including those in multi-story condominium complexes located in an SFHA in which flood insurance is available under the Act.

Proposed new question 25 would address lenders' options when a loan secured by a residential condominium unit is in a multi-unit complex
whose condominium association does not obtain or maintain the amount of flood insurance coverage required under the Regulation. Specifically,
it would provide that a lender must require the borrower to purchase an individual unit owner's dwelling policy in an amount sufficient to meet
the Regulation's flood insurance requirements. The proposed answer would also detail what is considered an adequate amount of flood
insurance under the Regulation and provide an example.

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Proposed new question 26 would address the steps a lender must take if the RCBAP coverage is insufficient to meet the Regulation's
mandatory purchase requirements for a loan secured by an individual residential condominium unit. The proposed answer would also summarize
some of the risks to which the lender and the individual unit owner/borrower may be exposed should a loss occur where the condominium
association did not maintain adequate flood insurance coverage under an RCBAP.

Proposed new question 28 would be added to explain how the RCBAP's co-insurance penalty applies when, at the time of loss, the RCBAP's
coverage amount is less than 80 percent of either the building's replacement cost or the maximum amount of flood insurance available for
that building under the NFIP (whichever is less). Examples of how to calculate the penalty would also be provided. Proposed new question 29
would be added to explain the interplay between the individual unit owner's dwelling policy coverage limitations and the RCBAP.

Section VII. Flood insurance requirements for home equity loans, lines of credit, subordinate liens, and other security interests in collateral located in an SFHA

Proposed new Section VII, which addresses flood insurance requirements for home equity loans, lines of credit, subordinate liens, and other security interests in collateral located in an SFHA, would include seven questions from current section I and parts of two questions from current section V. Specifically, current questions 3, 4, 5, 6, 7, 8, and 10 would be renumbered as questions 30, 31, 34, 35 and 36, 37, 38, and 39 respectively. Current question 5 in section V would be split into proposed questions 32 and

33.

Proposed questions and answers 30, 31, and 39 would include minor wording changes without any intended change in substance or meaning.
Proposed question 32 would expand on part of current section V, question 5, but would not change the substance of the answer. New question 34 would be revised to clarify the issue discussed in current question 5 of section I without any change in substance or meaning. New questions 35 and 36 would be added to clarify the issues discussed in current question 6 of section I.

Section VIII. Flood insurance requirements for loan syndications/participations

The Agencies are proposing to include a new section VIII and new question 40 in response to questions from lenders. The proposed question and answer would explain that, with respect to loan syndications and participations, individual participating lenders are responsible for ensuring compliance with flood insurance requirements. The Agencies believe that the risk of flood loss can be a significant threat to the value of improved real property securing loans, especially in light of many recent catastrophic flood-related events such as Hurricane Katrina. Therefore, the Agencies believe that each lender in a loan participation/syndication arrangement that is secured by improved real property located in a special flood hazard area should be responsible for ensuring that the respective interest of the lender in the collateral that secures the lender's portion of the loan is protected against the risk of flood loss, at least to the amount required by the Regulation. This does not mean that each lender in a syndication or participant in a loan must individually undertake such activities as obtaining a flood determination or monitoring whether flood insurance premiums are paid. Rather, it means that the participating lender should perform upfront due diligence to ensure both that the lead lender or agent has undertaken the necessary activities to ensure that the borrower obtains appropriate flood insurance and that the lead lender or agent has adequate controls to monitor the loan(s) on an on-going basis for compliance with the flood insurance requirements. The participating lender should require as a condition to the participation, syndication or other credit risk sharing agreement that the lead lender or agent will provide participating lenders with sufficient information on an ongoing basis to monitor compliance with flood insurance requirements.

Section IX. Flood insurance requirements in the event of the sale or transfer of a designated loan and/or its servicing rights

The heading to proposed section IX has been modified to provide greater clarity with no intended change in substance or meaning. The current questions 1, 2, 3, 4, 5, and 6 under current section IX would be renumbered as proposed questions 42, 43, 44, 45, 46, and 47, respectively, with minor revisions to questions and answers 42 and 46 to provide greater clarity, with no intended change in substance or meaning. Proposed section IX would also incorporate and expand current question 6 under section II as proposed question and answer 41.
Proposed question 41 would expound on the two scenarios from current question 6 to provide greater clarity, with no intended change in substance or meaning.

Section X. Escrow requirements

Current section IV on escrow requirements would be moved to proposed section X but would remain largely unchanged. Question 1 under
current section IV, relating to the date loan originations were subject to the escrow requirement, would be deleted, as it is now obsolete.
Questions 2 through 7 under current section IV would be renumbered as proposed questions 48 through 53, respectively, with minor changes for
greater clarity with no intended change in substance or meaning.

Section XI. Forced placement of flood insurance

For organizational purposes, the Agencies are proposing to move existing questions 1, 2, and 3 in Part VI to questions 54, 55, and 56 in section XI of the proposed document, respectively. The Agencies are proposing minor revisions to proposed question and answer 54 to provide greater clarity, with no intended change in substance or meaning.

Section XII. Gap insurance policies

The Agencies are proposing to add a new section and question and answer on the appropriateness of gap or blanket insurance policies, often purchased by lenders to ensure adequate life-of-loan flood insurance coverage for designated loans, as a result of questions received by the Agencies on such policies. Gap or blanket insurance policies are lender-paid private policies that are meant to cover a lender's entire portfolio of loans for insurance shortfalls or expired policies.

The proposed answer to question 57 of section XII would explain that, generally, gap or blanket insurance is not an adequate substitute for NFIP insurance, as a gap or blanket policy typically protects only the lender's, not the borrower's interest, and cannot be transferred when a loan is sold. The question and answer would acknowledge, however, that in limited circumstances, a gap or blanket policy may satisfy flood insurance obligations in instances where NFIP and private insurance for the borrower are otherwise unavailable.

Section XIII: Required use of the Standard Flood Hazard Determination Form (SFHDF)

Current section V would be moved to proposed section XIII, and questions 1, [[**Page** 15265]] 2, 3, and 4 of current section V would be renumbered as proposed questions 58, 59, 60, and 61, respectively. The Agencies are proposing some minor changes to the answers for these questions to provide additional clarity with no intended change in substance or meaning. For organizational purposes, the guidance found in question 5 of current
section V would be moved to proposed questions 32 and 33 under proposed section VII, as discussed above.

Section XIV. Flood determination fees

Current section VII would be moved to proposed section XIV. Questions 1 and 2 in current section VII would be renumbered as questions 62 and 63, respectively, with only minor language modifications, with no intended change in substance or meaning.

Section XV. Flood zone discrepancies

The Agencies are proposing a new section and two new questions concerning issues where there is a discrepancy between the flood hazard zone designation on a flood hazard determination form and the flood hazard zone designation on the flood insurance policy. Proposed new question 64 would address how lenders should respond when confronted with a discrepancy between the flood hazard zone designations on the flood hazard determination form and the flood insurance policy. The question discusses the legitimate reasons why such discrepancies may exist and describes how to resolve differences if there is no legitimate reason for them. Proposed question 65 discusses when such flood zone discrepancies in a loan portfolio will result in a finding that the lender violated federal flood insurance requirements. If there are repeated instances in the lender's loan portfolio of discrepancies between the flood hazard zone listed on a flood hazard determination and the flood hazard zone listed on a flood insurance policy, and the lender has not taken steps to resolve such discrepancies, then an agency may find that the lender has violated the mandatory purchase requirements.

Section XVI. Notice of special flood hazards and availability of Federal disaster relief

The Agencies propose to move current section VIII to proposed section XVI. Therefore, questions 1, 2, 3, 4, 5, and 6 under current section VIII would be renumbered as proposed questions 66, 67, 68, 69, 70, and 71, respectively, with nonsubstantive changes made to provide additional clarity to the answers. For organizational purposes, question 1 under current section X would be consolidated under this new section XVI and renumbered as question 73. Furthermore, a new question 72 is proposed to be added to clarify that the Notice of Special Flood Hazards must be provided to the borrower each time a loan is made, increased, extended, or renewed, even when a new determination is not required.

Section XVII. Mandatory civil money penalties

The Agencies are proposing a new section and two new questions concerning the imposition of mandatory civil money penalties for violations of the flood insurance requirements. Proposed new question 74 would list the sections of the Act that trigger mandatory civil money penalties when examiners find a pattern or practice of violations of those sections. The question would also include information about statutory limits on the amount of such penalties. Proposed new question 75 would discuss the general standards the Agencies consider when determining whether violations constitute a pattern or practice for which civil money penalties are mandatory. These considerations are not dispositive of individual cases, but serve as a reference point for reviewing the particular facts and circumstances.

Redesignation Table

The following redesignation table is provided as an aide to assist the public in reviewing the proposed revisions to the 1997 Interagency Questions and Answers.

Current	Proposed
Section I. Definitions:	
Section I, Question 1.....	Section IV, Question 17.
Section I, Question 2.....	Section IV, Question 16.
Section I, Question 3.....	Section VII, Question 30.
Section I, Question 4.....	Section VII, Question 31.

Section I, Question 5..... Section VII, Question 34.
Section I, Question 6..... Section VII, Question 35; and Section VII, Question 36.
Section I, Question 7..... Section VII, Question 37.
Section I, Question 8..... Section VII, Question 38.
Section I, Question 9..... Section I, Question 4.
Section I, Question 10.... Section VII, Question 39.

Section II. Requirement to Purchase Flood Insurance Where Available:
Section II, Question 1.... Section I, Question 1.
Section II, Question 2.... Section I, Question 3.
Section II, Question 3.... Section I, Question 5.
Section II, Question 4.... Deleted as obsolete.
Section II, Question 5.... Section II, Question 12.
Section II, Question 6.... Section IX, Question 41.
Section II, Question 7.... Section II, Question 11; and Section V, Question 22.
Section II, Question 8.... Section VI, Question 24.
Section II, Question 9.... Section VI, Question 27.

Section III. Exemptions....... Section III. Exemptions from the mandatory flood insurance requirements.
Section III, Question 1... Section III, Question 15.

Section IV. Escrow Requirements. Section X. Escrow requirements.
Section IV, Question 1.... Deleted as obsolete.
Section IV, Question 2.... Section X, Question 48.
Section IV, Question 3.... Section X, Question 49.

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Section IV, Question 4.... Section X, Question 50.
Section IV, Question 5.... Section X, Question 51.
Section IV, Question 6.... Section X, Question 52.
Section IV, Question 7.... Section X, Question 53.

Section V. Required Use of Standard Flood Hazard Determination Form (SFHDF). Section XIII. Required use of Standard Flood Hazard Determination Form (SFHDF).
Section V, Question 1..... Section XIII, Question 58.
Section V, Question 2..... Section XIII, Question 59.
Section V, Question 3..... Section XIII, Question 60.
Section V, Question 4..... Section XIII, Question 61.
Section V, Question 5..... Section VII, Question 32; and Section VII, Question 33.

Section VI. Forced Placement of Flood Insurance. Section XI. Forced placement of flood insurance.
Section VI, Question 1.... Section XI, Question 54.
Section VI, Question 2.... Section XI, Question 55.
Section VI, Question 3.... Section XI, Question 56.

Section VII. Determination Section XIV. Flood determination fees.

Fees.	
Section VII, Question 1...	Section XIV, Question 62.
Section VII, Question 2...	Section XIV, Question 63.
Section VIII. Notice of Special Flood Hazards and Availability of Federal Disaster Relief.	Section XVI. Notice of special flood hazards and availability of Federal disaster relief.
Section VIII, Question 1..	Section XVI, Question 66.
Section VIII, Question 2..	Section XVI, Question 67.
Section VIII, Question 3..	Section XVI, Question 68.
Section VIII, Question 4..	Section XVI, Question 69.
Section VIII, Question 5..	Section XVI, Question 70.
Section VIII, Question 6..	Section XVI, Question 71.
Section IX. Notice of Servicer's Identity.	Section IX. Flood insurance requirements in the event of the sale or transfer of a designated loan and/or its servicing rights.
Section IX, Question 1....	Section IX, Question 42.
Section IX, Question 2....	Section IX, Question 43.
Section IX, Question 3....	Section IX, Question 44.
Section IX, Question 4....	Section IX, Question 45.
Section IX, Question 5....	Section IX, Question 46.
Section IX, Question 6....	Section IX, Question 47.
Section X Appendix A to the Regulation-Sample Form of Notice of Special Flood Hazards and Availability of Federal Disaster Relief Assistance.	Section XVI. Notice of special flood hazards and availability of Federal disaster relief.
Section X, Question 1.....	Section XVI, Question 73.

Public Comments

The Agencies invite public comment on the proposed new and revised Interagency Questions and Answers. If financial institutions, bank examiners, community groups, or other interested parties have unanswered questions or comments about the Agencies' flood insurance regulations, they should submit them to the Agencies. The Agencies will consider including these questions and answers in the final guidance.

Solicitation of Comments Regarding the Use of ``Plain Language''

Section 722 of the Gramm-Leach-Bliley Act of 1999, 12 U.S.C. 4809, requires the federal banking Agencies to use ``plain language'' in all proposed and final rules published after January 1, 2000. Although this proposed guidance is not a proposed rule, comments are nevertheless

invited on whether the proposed interagency questions and answers are stated clearly and effectively organized, and how the guidance might be
revised to make it easier to read.

The text of the proposed Interagency Questions and Answers follows:

Interagency Questions and Answers Regarding Flood Insurance

The Interagency Questions and Answers are organized by topic. Each topic addresses a major area of the revised flood insurance law and
regulations. For ease of reference, the following terms are used throughout this document: ``Act'' refers to the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973, as revised by the National Flood Insurance Reform Act of 1994 (codified at 42 U.S.C. 4001 et seq.). ``Regulation'' refers to each agency's current final rule.\7\ The OCC, Board, FDIC, OTS, NCUA, and FCA (collectively, ``the Agencies'') are providing answers to questions pertaining to the following topics:

\7\ The Agencies' rules are codified at 12 CFR part 22 (OCC), 12 CFR part 208 (Board), 12 CFR part 339 (FDIC), 12 CFR part 572 (OTS),
12 CFR part 614 (FCA), and 12 CFR part 760 (NCUA).

I. Determining when certain loans are designated loans for which flood insurance is required under the Act and Regulation.
II. Determining the appropriate amount of flood insurance required under the Act and Regulation.
III. Exemptions from the mandatory flood insurance requirements.
IV. Flood insurance requirements for construction loans.
V. Flood insurance requirements for agricultural buildings.
VI. Flood insurance requirements for [[**Page** 15267]] residential condominiums.
VII. Flood insurance requirements for home equity loans, lines of credit, subordinate liens, and other security interests in collateral located in an SFHA.
VIII. Flood insurance requirements for loan syndications/participations.
IX. Flood insurance requirements in the event of the sale or transfer of a designated loan and/or its servicing rights.
X. Escrow requirements.
XI. Forced placement of flood insurance.
XII. Gap insurance policies.
XIII. Required use of Standard Flood Hazard Determination Form (SFHDF).
XIV. Flood determination fees.
XV. Flood zone discrepancies.
XVI. Notice of special flood hazards and availability of Federal disaster relief.
XVII. Mandatory civil money penalties.

I. Determining When Certain Loans Are Designated Loans for Which Flood Insurance is Required Under the Act and Regulation

1. Does the Regulation apply to a loan where the building or mobile home securing such loan is located in a community that does not *participate in the National Flood Insurance Program (NFIP)?*

Answer: Yes. The Regulation does apply; however, a lender need not require borrowers to obtain flood insurance for a building or mobile home located in a community that does not participate in the NFIP, even if the building or mobile home securing the loan is located in a Special Flood Hazard Area (SFHA). Nonetheless, a lender, using the standard Special Flood Hazard Determination Form (SFHDF), must still determine whether the building or mobile home is located in an SFHA. If the building or mobile home is determined to be located in an SFHA, a lender is required to notify the borrower. In this case, a lender, generally, may make a conventional loan without requiring flood insurance, if it chooses to do so. However, a lender may not make a Government-guaranteed or insured loan, such as an SBA, VA, or FHA, loan secured by a building or mobile home located in an SFHA in a community that does not participate in the NFIP. See 42 U.S.C. 4106(a). Also, a lender is responsible for exercising sound risk management practices to ensure that it does not make a loan secured by a building or mobile home located in an SFHA where no flood insurance is available, if doing so would be an unacceptable risk.

2. What is a lender's responsibility if a particular building or mobile home that secures a loan, due to a map change, is no longer located within an SFHA?

Answer: The lender is no longer obligated to require mandatory flood insurance; however, the borrower can elect to convert the existing NFIP policy to a Preferred Risk Policy. For risk management purposes, the lender may, by contract, continue to require flood insurance coverage.

3. Does a lender's purchase of a loan, secured by a building or mobile home located in an SFHA in which flood insurance is available under the Act, from another lender trigger any requirements under the Regulation?

Answer: No. A lender's purchase of a loan, secured by a building or mobile home located in an SFHA in which flood insurance is available under the Act, alone, is not an event that triggers the Regulation's requirements, such as making a new flood determination or requiring a borrower to purchase flood insurance. Requirements under the Regulation, generally, are triggered when a lender makes, increases, extends, or renews a designated loan. A lender's purchase of a loan does not fall within any of those categories.

However, if a lender becomes aware at any point during the life of a designated loan that flood insurance is required, the lender must comply with the Regulation, including force placing insurance, if necessary. Depending upon the circumstances, safety and soundness considerations may sometimes necessitate such due diligence upon purchase of a loan as to put the lender on notice of lack of adequate flood insurance. If the purchasing lender subsequently extends, increases, or renews a designated loan, it must also comply with the Regulation.

4. Does the Regulation apply to loans that are being restructured because of the borrower's default on the original loan?

Answer: Yes, if the loan otherwise meets the definition of a designated loan and if the lender increases the amount of the loan, or extends or renews the terms of the original loan.

5. Are table funded loans treated as new loan originations?

Answer: Yes. Table funding, as defined under HUD's Real Estate Settlement Procedure Act (RESPA) rule, 24 CFR 3500.2, is a settlement at which a loan is funded by a contemporaneous advance of loan funds and the assignment of the loan to the person advancing the funds. A loan made through a table funding process is treated as though the party advancing the funds has originated the loan. The funding party is required to comply with the Regulation. The table funding lender can meet the administrative requirements of the Regulation by requiring the party processing and underwriting the application to perform those functions on its behalf.

6. Is a lender required to perform a review of its, or its servicer's, existing loan portfolio for compliance with the flood insurance requirements under the Act and Regulation?

Answer: No. Apart from the requirements mandated when a loan is made, increased, extended, or renewed, a regulated lender need only review and take action on any part of its existing portfolio for safety and soundness purposes, or if it knows or has reason to know of the need for NFIP coverage. Regardless of the lack of such requirement in the Act and Regulation, however, sound risk management practices may lead a lender to conduct scheduled periodic reviews that track the need for flood insurance on a loan portfolio.

II. Determining the Appropriate Amount of Flood Insurance Required Under the Act and Regulation

7. The Regulation states that the amount of flood insurance required ``must be at least equal to the lesser of the outstanding principal balance of the designated loan or the maximum limit of coverage available for the particular type of property under the Act.'' What is meant by the ``maximum limit of coverage available for the particular type of property under the Act''?

Answer: ``The maximum limit of coverage available for the particular type of property under the Act'' depends on the value of the secured collateral. First, under the NFIP, there are maximum caps on the amount of insurance available. For single-family and two-to-four family dwellings and other residential buildings located in a participating community under the regular program, the maximum cap is $250,000. For nonresidential structures located in a participating community under the regular program, the maximum cap is $500,000. (In participating communities that are under the emergency program phase, the caps are $35,000 for single-family and two-to-four family dwellings and other residential structures, and $100,000 for nonresidential structures).

In addition to the maximum caps under the NFIP, the Regulation also provides that ``flood insurance coverage under the Act is limited to the overall value of the property securing the designated loan minus the value of the land on which the property is located,'' which is commonly referred to as the ``insurable value'' of a structure. The NFIP does not insure land; therefore, land values should not be

included in [[**Page** 15268]] the calculation. An NFIP policy will not cover an amount exceeding the ``insurable value'' of the structure. In determining coverage amounts for flood insurance, lenders often follow the same practice used to establish other hazard insurance coverage amounts. However, unlike the insurable valuation used to underwrite most other hazard insurance policies, the insurable value of improved real property for flood insurance purposes also includes the repair or replacement cost of the foundation and supporting structures. It is very important to calculate the correct insurable value of the property; otherwise, the lender might inadvertently require the borrower to purchase too much or too little flood insurance coverage. For example, if the lender fails to exclude the value of the land when determining the insurable value of the improved real property, the borrower will be asked to purchase coverage that exceeds the amount the NFIP will pay in the event of a loss. (Please note, however, when taking a security interest in
improved real property where the value of the land, excluding the value of the improvements, is sufficient collateral for the debt, the lender must nonetheless require flood insurance to cover the value of the structure if it is located in a participating community's SFHA).

8. What are examples of residential buildings?

Answer: Residential buildings include one-to-four family dwellings; apartment or other residential buildings containing more than four dwelling units; condominiums and cooperatives in which at least 75 percent of the square footage is residential; hotels or motels where the normal occupancy of a guest is six months or more; and rooming houses that have more than four roomers. A residential building may have incidental non-residential use, such as an office or studio, as long as the total area of such incidental occupancy is limited to less than 25 percent of the square footage of the building.

9. What are examples of nonresidential buildings?

Answer: Nonresidential buildings include small business concerns, churches, schools, farm buildings (including grain bins and silos), pool houses, clubhouses, recreational buildings, mercantile structures, agricultural and industrial structures, warehouses, hotels and motels with normal room rentals for less than six months' duration, nursing homes, and mixed-use buildings with less than 75 percent residential square footage.

10. How much insurance is required on a building located in an SFHA in a participating community?

Answer: The amount of insurance required by the Act and Regulation is the lesser of:
- The outstanding principal balance of the loan(s) or
- The maximum amount of insurance available under the NFIP, which is the lesser of:
    - The maximum limit available for the type of structure or
    - The ``insurable value'' of the structure (see Question 7).

Example: (calculating insurance required on a non-residential building): Loan security includes one equipment shed located in an SFHA in a participating community under the regular program.
- Outstanding loan principal is $300,000
- Maximum amount of insurance available under the NFIP:
    - Maximum limit available for type of structure is $500,000 per building (non-residential building)
    - Insurable value of the equipment shed is $30,000

The minimum amount of insurance required by the Regulation for the equipment shed is $30,000.

11. Is flood insurance required for each building when the real estate security contains more than one building located in an SFHA in a participating community? If so, how much coverage is required?

Answer: Yes. The lender must determine the amount of insurance required on each building and add these individual amounts together.
The total amount of required flood insurance is the lesser of:

- the outstanding principal balance of the loan(s) or
- the maximum amount of insurance available under the NFIP,

which is the lesser of:

  - the maximum limit available for the type of structures or
  - the ``insurable value" of the structures (see Question 7).

The amount of total required flood insurance can be allocated among the secured buildings in varying amounts, but all buildings in an SFHA
must have some coverage.

Example: Lender makes a loan in the principal amount of $150,000 secured by five nonresidential buildings, only three of which are located in SFHAs within participating communities.

- Outstanding loan principal is $150,000
- Maximum amount of insurance available under the NFIP
  - Maximum limit available for the type of structure is $500,000 per building (non-residential buildings); or
  - Insurable value (for each non-residential building for which insurance is required, which is $100,000, or $300,000 total)

Amount of insurance required for the three buildings is $150,000. This amount of required flood insurance could be allocated among the
three buildings in varying amounts, so long as each is covered by flood insurance.

12. If the insurable value of a building or mobile home, located in an SFHA in which flood insurance is available under the Act, securing a designated loan is less than the outstanding principal balance of the loan, must a lender require the borrower to obtain flood insurance up to the balance of the loan?

Answer: No. The Regulation provides that the amount of flood insurance must be at least equal to the lesser of the outstanding principal balance of the designated loan or the maximum limit of coverage available for a particular type of property under the Act. The Regulation also provides that flood insurance coverage under the Act is limited to the overall value of the property securing the designated loan minus the value of the land on which the building or mobile home is located. Since the NFIP policy does not cover land value, lenders should determine the amount of insurance necessary based on the insurable value of the improvements.

13. Can a lender require more flood insurance than the minimum required by the Regulation?

Answer: Yes. Lenders are permitted to require more flood insurance coverage than required by the Regulation. The borrower or lender may
have to seek such coverage outside the NFIP. Each lender has the responsibility to tailor its own flood insurance policies and procedures to suit its business needs and protect its ongoing interest in the collateral. Lenders should avoid creating situations where a building is being ``over-insured".

14. Can a lender allow the borrower to use the maximum deductible to reduce the cost of flood insurance?

Answer: Yes. However, it is not a sound business practice for a lender to allow the borrower to use the maximum deductible amount in every situation. A lender should determine the reasonableness of the

deductible on a case-by-case basis, taking into account the risk that such a deductible would pose to the borrower and lender. A lender may not allow the borrower to use a deductible amount equal to the [[
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insurable value of the property to avoid the mandatory purchase requirement for flood insurance.

III. Exemptions From the Mandatory Flood Insurance Requirements

15. What are the exemptions from coverage?

Answer: There are only two exemptions from the purchase requirements. The first applies to state-owned property covered under a policy of self-insurance satisfactory to the Director of FEMA. The second applies if both the original principal balance of the loan is $5,000 or less, and the original repayment term is one year or less.

IV. Flood Insurance Requirements for Construction Loans

16. Is a loan secured by raw land that is located in an SFHA in which flood insurance is available under the Act and that will be developed into buildable lot(s) a designated loan that requires flood insurance?

Answer: No. A designated loan is defined as a loan secured by a building or mobile home that is located or to be located in an SFHA in which flood insurance is available under the Act. Any loan secured by only raw land that is located in an SFHA in which flood insurance is available is not a designated loan since it is not secured by a building or mobile home.

17. Is a loan secured or to be secured by a building in the course of construction that is located or to be located in an SFHA in which flood insurance is available under the Act a designated loan?

Answer: Yes. Therefore, a lender must always make a flood determination prior to loan origination to determine whether a building to be constructed that is security for the loan is located or will be located in an SFHA in which flood insurance is available under the Act. If so, then the loan is a designated loan and the lender must provide the requisite notice to the borrower prior to loan origination that mandatory flood insurance is required. The lender must then comply with the mandatory purchase requirement under the Act and Regulation.

18. Is a building in the course of construction that is located in an SFHA in which flood insurance is available under the Act eligible for coverage under an NFIP policy?

Answer: Yes. FEMA's Flood Insurance Manual, under general rules, states:

> buildings in the course of construction that have yet to be walled and roofed are eligible for coverage except when construction has been halted for more than 90 days and/or if the lowest floor used for rating purposes is below the Base Flood Elevation (BFE).

> Materials or supplies intended for
> use in such construction, alteration,
> or repair are not insurable unless
> they are contained within an
> enclosed building on the premises
> or adjacent to the premises.

Flood Insurance Manual at p. GR 4 (October 2006). The definition section of the Flood Insurance Manual defines ``start of construction'' in the case of new construction as ``either the first placement of permanent construction of a building on site, such as the pouring of a slab or footing, the installation of piles, the construction of columns, or any work beyond the stage of excavation; or the placement of a manufactured (mobile) home on a foundation.'' Flood Insurance Manual at p. DEF 9. While an NFIP policy may be purchased prior to the start of construction, as a practical matter, coverage under an NFIP policy is not effective until actual construction commences or when materials or supplies intended for use in such construction, alteration, or repair are contained in an enclosed building on the premises or adjacent to the premises.

19. When must a lender require the purchase of flood insurance for a loan secured by a building in the course of construction that is located in an SFHA in which flood insurance is available?

Answer: Under the Act, as implemented by the Regulation, a lender may not make, increase, extend, or renew any loan secured by a building or a mobile home, located or to be located in an SFHA in which flood insurance is available, unless the property is covered by adequate flood insurance for the term of the loan. One way for lenders to comply with the mandatory purchase requirement for a loan secured by a building in the course of construction that is located in an SFHA is to require borrowers to have a flood insurance policy in place at the time of loan origination.

Alternatively, a lender may allow a borrower to defer the purchase of flood insurance until a foundation slab has been poured and/or an elevation certificate has been issued, provided that the lender requires the borrower to have flood insurance in place before the lender disburses funds to pay for building construction (except as necessary to pour the slab or perform preliminary site work, such as laying utilities, clearing brush, or the purchase and/or delivery of building materials) on the property securing the loan. If the lender elects this approach and does not require flood insurance to be obtained at loan origination, then it must have adequate internal controls in place at origination to ensure that the borrower obtains flood insurance no later than when the foundation slab has been poured and/or an elevation certificate has been issued.

20. Does the 30-day waiting period apply when the purchase of the flood insurance policy is deferred in connection with a construction loan?

Answer: No. The NFIP will rely on an insurance agent's representation on the application for flood insurance that the purchase of insurance has been properly deferred unless there is a loss during the first 30 days of the policy period. In that case, the NFIP will require documentation of the loan transaction, such as settlement papers, before adjusting the loss.

V. Flood Insurance Requirements for Agricultural Buildings

21. Some agricultural operations have buildings on their farms with limited utility to the farming *operation and, in many cases, the farmer would not replace such buildings if lost in a flood. Is a lender required to mandate flood insurance for such buildings?*

Answer: Yes. Under the Regulation, lenders must require flood insurance on real estate improvements when those improvements are part of the property securing the loan and are located in an SFHA in a participating community. The Act does not differentiate agricultural lending from other types of lending.

The lender may consider ``carving out'' buildings from the security it takes on the loan. However, the lender should fully analyze the risks of this option. In particular, a lender should consider whether it would be able to market the property securing its loan in the event of foreclosure. Additionally, the lender should consider any local zoning issues or other issues that would affect its collateral.

22. What are a lender's requirements under the Regulation for a loan secured by multiple agricultural buildings located throughout a large geographic area where some of the buildings are located in an SFHA in which flood insurance is available and other buildings are not? What if the buildings are located in several jurisdictions or counties where some of the communities participate in the NFIP, and others do not?

Answer: A lender is required to make a determination as to whether the property securing the loan is in an SFHA. If secured property is
located in an SFHA, but not in a participating [[**Page** 15270]] community, no flood insurance is required, although a lender can require the purchase of flood insurance (from a private insurer) as a matter of safety and soundness. Conversely, where a secured property is located in a participating community but not in an SFHA, no insurance is required. A lender must provide appropriate notice and require the purchase of flood insurance for designated loans located in an SFHA in a participating community. Agricultural buildings that are part of the loan's security and are located in an SFHA in a participating community are required to have flood insurance.

VI. Flood Insurance Requirements for Residential Condominiums

23. Are residential condominiums, including multi-story condominium complexes, subject to the statutory and regulatory requirements for flood insurance?

Answer: Yes. The mandatory flood insurance purchase requirements under the Act and Regulation apply to loans secured by individual
residential condominium units, including those located in multi-story condominium complexes, located in an SFHA in which flood insurance is
available under the Act. The mandatory purchase requirements also apply to loans secured by other condominium property, such as loans to a
developer for construction of the condominium or loans to a condominium association.

24. What is the amount of flood insurance coverage that a lender must require with respect to residential condominium units, including those located in multi-story condominium complexes, to comply with the mandatory purchase requirements under the Act and the Regulation?

Answer: To comply with the Regulation, the lender must ensure that the minimum amount of flood insurance covering the condominium unit is
the lesser of:

- The outstanding principal balance of the loan(s) or
- The maximum amount of insurance available under the NFIP, which is the lesser of:
  - The maximum limit available for the residential condominium unit or
  - The ``insurable value" allocated to the residential condominium unit, which is the replacement cost value of the condominium building divided by the number of units.

Assuming that the outstanding principal balance of the loan is greater than the maximum amount of coverage available under the NFIP, the lender must require a borrower whose loan is secured by a residential condominium unit to either:

- Ensure the condominium owners association has purchased an NFIP Residential Condominium Building Association Policy (RCBAP) covering either 100 percent of the insurable value (replacement cost) of the building, including amounts to repair or replace the foundation and its supporting structures, or the total number of units in the condominium building times $250,000, whichever is less; or
- Obtain a dwelling policy if there is no RCBAP, as explained in Question 25, or if the RCBAP coverage is less than 100 percent of the replacement cost value of the building or the total number of units in the condominium building times $250,000, whichever is less, as explained in Question 26.

The RCBAP, which is a master policy for condominiums issued by FEMA, may only be purchased by the condominium owners association. The RCBAP covers both the common and individually owned building elements within the units, improvements within the units, and contents owned in common. The maximum amount of building coverage that can be purchased under an RCBAP is either 100 percent of the replacement cost value of the building, including amounts to repair or replace the foundation and its supporting structures, or the total number of units in the condominium building times $250,000, whichever is less.

The dwelling policy provides individual unit owners with supplemental building coverage to the RCBAP. The policies are coordinated such that the dwelling policy purchased by the unit owner responds to shortfalls on building coverages pertaining either to improvements owned by the insured unit owner or to assessments. However, the dwelling policy does not extend the RCBAP limits, nor does it enable the condominium association to fill in gaps in coverage.

Example: Lender makes a loan in the principal amount of $300,000 secured by a condominium unit in a 50-unit condominium building, which is located in an SFHA within a participating community, with a replacement cost of $15 million and insured by an RCBAP with $12.5 million of coverage.

- Outstanding principal balance of loan is $300,000;
- Maximum amount of coverage available under the NFIP, which is the lesser of:
  - Maximum limit available for the residential condominium unit is $250,000; or
  - Insurable value of the unit based on 100 percent of the building's replacement cost value ($15 million / 50 = $300,000).

The lender does not need to require additional flood insurance since the RCBAP's $250,000 per unit coverage ($12.5 million / 50 = $250,000) satisfies the Regulation's mandatory flood insurance requirement. (This is the lesser of the outstanding principal balance ($300,000), the maximum coverage available under the NFIP ($250,000), or the insurable value ($300,000).)

The guidance in question and answer 24 will apply to any loan that is made, increased, extended, or renewed after the effective date of the revised guidance. Further, the guidance will apply to any loan made prior to the effective date of the guidance, which a lender determines to be covered by flood insurance in an amount less than required by the Regulation, and as set forth in proposed question and answer 24, at the first flood insurance policy renewal period following the effective date of the revised guidance.

25. What action must a lender take if there is no RCBAP coverage?

Answer: If there is no RCBAP, either because the condominium association will not obtain a policy or because individual unit owners are responsible for obtaining their own insurance, then the lender must require the individual unit owner/borrower to obtain a dwelling policy in an amount sufficient to meet the requirements outlined in Question 24.

Example: The lender makes a loan in the principal amount of $175,000 secured by a condominium unit in a 50-unit condominium building, which is located in an SFHA within a participating community, with a replacement cost value of $10 million; however, there is no RCBAP.

- Outstanding principal balance of loan is $175,000.
- Maximum amount of coverage available under the NFIP, which is the lesser of:
    - Maximum limit available for the residential condominium unit is $250,000; or
    - Insurable value of the unit based on 100 percent of the building's replacement cost value ($10 million / 50 = $200,000).

The lender must require the individual unit owner/borrower to purchase a flood insurance dwelling policy in the amount of $175,000, since there is no RCBAP, to satisfy the Regulation's mandatory flood insurance requirement. (This is the lesser of the outstanding principal balance [[**Page** 15271]] ($175,000), the maximum coverage available under the NFIP ($250,000), or the insurable value ($200,000).)

26. What action must a lender take if the RCBAP coverage is insufficient to meet the Regulation's mandatory purchase requirements for a loan secured by an individual residential condominium unit?

Answer: If the lender determines that flood insurance coverage purchased under the RCBAP is insufficient to meet the Regulation's mandatory purchase requirements, then the lender should request the individual unit owner/borrower to ask the condominium association to obtain additional coverage that would be sufficient to meet the Regulation's requirements (see Question 24). If the condominium association does not obtain sufficient coverage, then the lender must require the individual unit owner/borrower to purchase a dwelling policy in an amount sufficient to meet the Regulation's flood insurance requirements. The amount of coverage under the dwelling policy required to be purchased by the individual unit owner would be the difference between the RCBAP's coverage allocated to that unit and the Regulation's mandatory flood insurance requirements (see Question 24).

Example: Lender makes a loan in the principal amount of $300,000 secured by a condominium unit in a 50-unit condominium building, which
is located in an SFHA within a participating community, with a replacement cost value of $10 million; however, the RCBAP is at 80 percent of replacement cost value ($8 million or $160,000 per unit).

- Outstanding principal balance of loan is $300,000
- Maximum amount of coverage available under the NFIP, which is the lesser of:
  - Maximum limit available for the residential condominium unit is $250,000; or
  - Insurable value of the unit based on 100 percent of the building's replacement value ($10 million / 50 = $200,000).

The lender must require the individual unit owner/borrower to purchase a flood insurance dwelling policy in the amount of $40,000 to satisfy the Regulation's mandatory flood insurance requirement of $200,000. (This is the lesser of the outstanding principal balance ($300,000), the maximum coverage available under the NFIP ($250,000), or the insurable value ($200,000).) The RCBAP fulfills only $160,000 of the Regulation's flood insurance requirement.

While the individual unit owner's purchase of a separate dwelling policy that provides for adequate flood insurance coverage under the Regulation will satisfy the Regulation's mandatory flood insurance requirements, the lender and the individual unit owner/borrower may still be exposed to additional risk of loss. Lenders are encouraged to apprise borrowers of this risk. The dwelling policy provides individual unit owners with supplemental building coverage to the RCBAP. The policies are coordinated such that the dwelling policy purchased by the unit owner responds to shortfalls on building coverages pertaining either to improvements owned by the insured unit owner or to assessments. However, the dwelling policy does not extend the RCBAP limits, nor does it enable the condominium association to fill in gaps in coverage.

The risk arises because the individual unit owner's dwelling policy may contain claim limitations that prevent the dwelling policy from covering the individual unit owner's share of the co-insurance penalty, which is triggered when the amount of insurance under the RCBAP is less than 80 percent of the building's replacement cost value at the time of loss. In addition, following a major flood loss, the insured unit owner may have to rely upon the condominium association's and other unit owners' financial ability to make the necessary repairs to common elements in the building, such as electricity, heating, plumbing, elevators, etc. It is incumbent on the lender to understand these limitations.

27. What must a lender do when a loan secured by a residential condominium unit is in a complex whose condominium association allows its existing RCBAP to lapse?

Answer: If a lender determines at any time during the term of a designated loan that the loan is not covered by flood insurance or is covered by such insurance in an amount less than that required under the Act and the Regulation, the lender must notify the individual unit owner/borrower of the requirement to maintain flood insurance coverage sufficient to meet the Regulation's mandatory requirements. The lender should encourage the individual unit owner/borrower to work with the condominium association to acquire a new RCBAP in an amount sufficient to meet the Regulation's mandatory flood insurance requirement (see Question 24). Failing that, the lender must require the individual unit owner/borrower to obtain a flood insurance dwelling policy in an amount sufficient to meet the Regulation's mandatory flood insurance requirement (see Questions 25 and 26). If the borrower/unit owner or the condominium association fails to purchase flood insurance sufficient to meet the Regulation's mandatory requirements within 45 days of the lender's notification to the individual unit owner/borrower of inadequate insurance coverage, the lender must force place the necessary flood insurance.

28. How does the RCBAP's co-insurance penalty apply in the case of residential condominiums, including those located in multi-story condominium complexes?

Answer: In the event the RCBAP's coverage on a condominium building at the time of loss is less than 80 percent of either the building's
replacement cost or the maximum amount of insurance available for that building under the NFIP (whichever is less), then the loss payment,
which is subject to a co-insurance penalty, is determined as follows (subject to all other relevant conditions in this policy, including those pertaining to valuation, adjustment, settlement, and payment of loss):

A. Divide the actual amount of flood insurance carried on the condominium building at the time of loss by 80 percent of either its replacement cost or the maximum amount of insurance available for the building under the NFIP, whichever is less.

B. Multiply the amount of loss, before application of the deductible, by the figure determined in A above.

C. Subtract the deductible from the figure determined in B above.

The policy will pay the amount determined in C above, or the amount of insurance carried, whichever is less.

Example 1: (inadequate insurance amount to avoid penalty)

Replacement value of the building--$250,000
80% of replacement value of the building--$200,000
Actual amount of insurance carried--$180,000
Amount of the loss--$150,000
Deductible--$500
Step A: 180,000 / 200,000 = .90
(90% of what should be carried to avoid co-insurance penalty)
Step B: 150,000 x .90 = 135,000
Step C: 135,000 - 500 = 134,500

The policy will pay no more than $134,500. The remaining $15,500 is not covered due to the co-insurance penalty ($15,000) and application of the deductible ($500). Unit owners' dwelling policies will not cover any [[**Page** 15272]] assessment that may be imposed to cover the costs of repair that are not covered by the RCBAP.

Example 2: (adequate insurance amount to avoid penalty)

Replacement value of the building--$250,000
80% of replacement value of the building--$200,000
Actual amount of insurance carried--$200,000
Amount of the loss--$150,000
Deductible--$500
Step A: 200,000 / 200,000 = 1.00
(100% of what should be carried to avoid co-insurance penalty)
Step B: 150,000 x 1.00 = 150,000
Step C: 150,000 - 500 = 149,500

In this example there is no co-insurance penalty, because the actual amount of insurance carried meets the 80 percent requirement to avoid the co-insurance penalty. The policy will pay no more than $149,500 ($150,000 amount of loss minus the $500 deductible). This example also assumes a $150,000 outstanding principal loan balance.

29. What are the major factors involved with the individual unit owner's dwelling policy's coverage limitations with respect to the condominium association's RCBAP coverage?

Answer: The following examples demonstrate how the unit owner's dwelling policy may cover in certain loss situations:

Example 1: (RCBAP insured to at least 80 percent of building replacement cost)

- If the unit owner purchases building coverage under the dwelling policy and if there is an RCBAP covering at least 80 percent of the building replacement cost value, the loss assessment coverage under the dwelling policy will pay that part of a loss that exceeds 80 percent of the association's building replacement cost allocated to that unit.
- The loss assessment coverage under the dwelling policy will not cover the association's policy deductible purchased by the condominium association.
- If building elements within units have also been damaged, the dwelling policy pays to repair building elements after the RCBAP limits that apply to the unit have been exhausted. Coverage combinations cannot exceed the total limit of $250,000 per unit.

Example 2: (RCBAP insured to less than 80 percent of building replacement cost)

- If the unit owner purchases building coverage under the dwelling policy and there is an RCBAP that was insured to less than 80 percent of the building replacement cost value at the time of loss, the loss assessment coverage cannot be used to reimburse the association for its co-insurance penalty.
- Loss assessment is available only to cover the building damages in excess of the 80-percent required amount at the time of loss. Thus, the covered damages to the condominium association building must be greater than 80 percent of the building replacement cost value at the time of loss before the loss assessment coverage under the dwelling policy becomes available. Under the dwelling policy, covered repairs to the unit, if applicable, would have priority in payment over loss assessments against the unit owner.

Example 3: (No RCBAP)

- If the unit owner purchases building coverage under the dwelling policy and there is no RCBAP, the dwelling policy covers assessments against unit owners for damages to common areas up to the dwelling policy limit.
- However, if there is damage to the building elements of the unit as well, the combined payment of unit building damages, which would apply first, and the loss assessment may not exceed the building coverage limit under the dwelling policy.

VII. Flood Insurance Requirements for Home Equity Loans, Lines of Credit, Subordinate Liens, and Other Security Interests in Collateral Located in an SFHA

30. Is a home equity loan considered a designated loan that requires flood insurance?

Answer: Yes. A home equity loan is a designated loan, regardless of the lien priority, if the loan is secured by a building or a mobile home located in an SFHA in which flood insurance is available under the Act.

31. Does a draw against an approved line of credit secured by a building or mobile home, which is located in an SFHA in which flood insurance is available under the Act, require a flood determination under the Regulation?

Answer: No. While a line of credit, secured by a building or mobile home located in an SFHA in which flood insurance is available under the
Act, is a designated loan and, therefore, requires a flood determination when application is made for the loan, draws against an approved line do not require further determinations. However, a request made for an increase in an approved line of credit may require a new determination, depending upon whether a previous determination was done. (See the response to Question 61 in Section XIII. Required use of Standard Flood Hazard Determination Form).

32. When a lender makes a second mortgage secured by a building or mobile home located in an SFHA, how much flood insurance must the lender require?

Answer: A lender must ensure that adequate flood insurance is in place or require that additional flood insurance coverage be added to
the flood insurance policy in the amount of the lesser of either the combined total outstanding principal balance of the first and second
loan, the maximum amount available under the Act (currently $250,000 for a residential building and $500,000 for a nonresidential building),
or the insurable value of the building or mobile home. The lender on the second mortgage cannot comply with the Act and Regulation by
requiring flood insurance only in the amount of the outstanding principal balance of the second mortgage without regard to the amount
of flood insurance coverage on a first mortgage.

Example 1: Lender A makes a first mortgage with a principal balance of $100,000, but improperly requires only $75,000 of flood insurance
coverage. Lender B issues a second mortgage with a principal balance of $50,000. The insurable value of the residential building securing the
loans is $200,000. Lender B must ensure that flood insurance in the amount of $150,000 is purchased and maintained. If Lender B were to
require flood insurance only in an amount equal to the principal balance of the second mortgage ($50,000), its interest in the secured
property would not be fully protected in the event of a flood loss because Lender A would have prior claim on the entire $100,000 of the
loss payment towards its principal balance of $100,000, while Lender B would receive only $25,000 of the loss payment toward its principal
balance of $50,000.

Example 2: Lender A, who is not directly covered by the Act or Regulation, makes a first mortgage with a principal balance of $100,000
and does not require flood insurance. Lender B, who is directly covered by the Act and Regulation, issues a second mortgage with a principal

balance of $50,000. The insurable value of the residential building securing the loans is $200,000. Lender B must ensure that flood insurance in the amount of $150,000 is purchased and maintained. If Lender B were to require flood insurance only in an amount equal to the principal balance of the second [[**Page** 15273]] mortgage ($50,000), its interest in the secured property would not be protected in the event of a flood loss because Lender A would have prior claim on the entire $50,000 loss payment towards its principal balance of $100,000.

Example 3: Lender A made a first mortgage with a principal balance of $100,000 on real property with a fair market value of $150,000. The insurable value of the residential building on the real property is $90,000; however, Lender A improperly required only $70,000 of flood insurance coverage. Lender B later takes a second mortgage on the property with a principal balance of $10,000. Lender B must ensure that flood insurance in the amount of $90,000 is purchased and maintained on the secured property to comply with the Act and Regulation.

33. If a borrower requesting a home equity loan secured by a junior lien provides evidence that flood insurance coverage is in place, does the lender have to make a new determination? Does the lender have to adjust the insurance coverage?

Answer: It depends. Assuming the requirements in Section 528 of the Act (42 U.S.C. 4104b) are met and the same lender made the first mortgage, then a new determination may not be necessary, when the existing determination is not more than seven years old, there have been no map changes, and the determination was recorded on an SFHDF. If, however, a lender other than the one that made the first mortgage loan is making the home equity loan, a new determination would be required because this lender would be deemed to be ``making'' a new loan. In either situation, the lender will need to determine whether the amount of insurance in force is sufficient to cover the lesser of the combined outstanding principal balance of all loans (including the home equity loan), the insurable value, or the maximum amount of coverage available on the improved real estate.

34. If the loan request is to finance inventory stored in a building located within an SFHA, but the building is not security for the loan, is flood insurance required?

Answer: No. The Act and the Regulation provide that a lender shall not make, increase, extend, or renew a designated loan, that is a loan secured by a building or mobile home located or to be located in an SFHA, ``unless the building or mobile home and any personal property securing such loan'' is covered by flood insurance for the term of the loan. In this example, the collateral is not the type that could secure a designated loan because it does not include a building or mobile home; rather, the collateral is the inventory alone.

35. Is flood insurance required if a building and its contents both secure a loan, and the building is located in an SFHA in which flood insurance is available?

Answer: Yes. Flood insurance is required for the building located in the SFHA and any contents stored in that building.

36. If a loan is secured by Building A, which is located in an SFHA, and contents, which are located in Building B, is flood insurance required on the contents securing a loan?

Answer: No. If collateral securing the loan is stored in Building B, which does not secure the loan, then flood insurance is not required on those contents whether or not Building B is located in an SFHA.

37. Does the Regulation apply where the lender takes a security interest in a building or mobile home located in an SFHA only as an ``abundance of caution''?

Answer: Yes. The Act and Regulation look to the collateral securing the loan. If the lender takes a security interest in improved real estate located in an SFHA, then flood insurance is required.

38. If a borrower offers a note on a single-family dwelling as collateral for a loan but the lender does not take a security interest in the dwelling itself, is this a designated loan that requires flood insurance?

Answer: No. A designated loan is a loan secured by a building or mobile home. In this example, the lender did not take a security interest in the building; therefore, the loan is not a designated loan.

39. If a lender makes a loan that is not secured by real estate, but is made on the condition of a personal guarantee by a third party who gives the lender a security interest in improved real estate owned by the third party that is located in an SFHA in which flood insurance is available, is it a designated loan that requires flood insurance?

Answer: Yes. The making of a loan on condition of a personal guarantee by a third party and further secured by improved real estate, which is located in an SFHA, owned by that third party is so closely tied to the making of the loan that it is considered a designated loan that requires flood insurance.

VIII. Flood Insurance Requirements for Loan Syndications/Participations

40. How do the Agencies enforce the mandatory purchase requirements under the Act and Regulation when a lender participates in a loan syndication/participation?

Answer: Although a syndication/participation agreement may assign compliance duties to the lead lender or agent, and include clauses in
which the lead lender or agent indemnifies participating lenders against flood losses, each participating lender remains individually responsible for ensuring compliance with the Act and Regulation. Therefore, the Agencies will examine whether the regulated institution/participating lender has performed upfront due diligence to ensure both that the lead lender or agent has undertaken the necessary activities to ensure that the borrower obtains appropriate flood insurance and that the lead lender or agent has adequate controls to monitor the loan(s) on an on-going basis for compliance with the flood insurance requirements. Further, the Agencies expect the participating lender to have adequate controls to monitor the activities of the lead lender or agent to ensure compliance with flood insurance requirements over the term of the loan.

IX. Flood Insurance Requirements in the Event of the Sale or Transfer of a Designated Loan and/or its Servicing Rights

41. How do the flood insurance requirements under the Regulation apply to lenders under the following scenarios involving loan servicing?

Scenario 1: A regulated lender originates a designated loan secured by a building or mobile home located in an SFHA in which flood insurance is available under the Act. The lender makes the initial flood determination, provides the borrower with appropriate notice, and flood insurance is obtained. The lender initially services the loan; however, the lender subsequently sells both the loan and the servicing rights to a non-regulated party. What are the regulated lender's requirements under the Regulation? What are the regulated lender's requirements under the Regulation if it only transfers or sells the servicing rights, but retains ownership of the loan?

Answer: The lender must comply with all requirements of the Regulation, including making the initial flood determination, providing appropriate notice to the borrower, and ensuring that the proper amount of insurance is obtained. In the event the lender sells or transfers the loan and servicing rights, the lender must provide notice of the identity of the new servicer to FEMA or its designee.

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If the lender retains ownership of the loan and only transfers or sells the servicing rights to a non-regulated party, the lender must notify FEMA or its designee of the identity of the new servicer. The servicing contract should require the servicer to comply with all the requirements that are imposed on the lender as owner of the loan, including escrow of insurance premiums and forced placement of insurance, if necessary.

Generally, the Regulation does not impose obligations on a loan servicer independent from the obligations it imposes on the owner of a loan. Loan servicers are covered by the escrow, forced placement, and flood hazard determination fee provisions of the Act and Regulation primarily so that they may perform the administrative tasks for the lender, without fear of liability to the borrower for the imposition of unauthorized charges. In addition, the preamble to the Regulation emphasizes that the obligation of a loan servicer to fulfill administrative duties with respect to the flood insurance requirements arises from the contractual relationship between the loan servicer and the lender or from other commonly accepted standards for performance of servicing obligations. The lender remains ultimately liable for fulfillment of those responsibilities, and must take adequate steps to ensure that the loan servicer will maintain compliance with the flood insurance requirements.

Scenario 2: A non-regulated lender originates a designated loan, secured by a building or mobile home located in an SFHA in which flood insurance is available under the Act. The non-regulated lender does not make an initial flood determination or notify the borrower of the need to obtain insurance. The non-regulated lender sells the loan and servicing rights to a regulated lender. What are the regulated lender's requirements under the Regulation? What are the regulated lender's requirements if it only purchases the servicing rights?

Answer: A regulated lender's purchase of a loan and servicing rights, secured by a building or mobile home located in an SFHA in which flood insurance is available under the Act, is not an event that triggers any requirements under the Regulation, such as making a new flood determination or requiring a borrower to purchase flood insurance. The Regulation's requirements are triggered when a lender makes, increases, extends, or renews a designated loan. A lender's purchase of a loan does not fall within any of those categories. However, if a regulated lender becomes aware at any point during the life of a designated loan that flood insurance is required, then the lender must comply with the Regulation, including force placing insurance, if necessary. Similarly, if the lender subsequently extends, increases, or renews a designated loan, the lender must also comply with the Regulation.

Where a regulated lender purchases only the servicing rights to a loan originated by a non-regulated lender, the regulated lender is obligated only to follow the terms of its servicing contract with the owner of the loan. In the event the regulated lender subsequently sells or transfers the servicing rights on that loan, the lender must notify FEMA or its designee of the identity of the new servicer, if required to do so by the servicing contract with the owner of the loan.

42. When a lender makes a designated loan and will be servicing that loan, what are the requirements for notifying the Director of FEMA or the Director's designee?

Answer: FEMA stated in a June 4, 1996, letter that the Director's designee is the insurance company issuing the flood insurance policy.
The borrower's purchase of a policy (or the lender's forced placement of a policy) will constitute notice to FEMA when the lender is servicing that loan.

In the event the servicing is subsequently transferred to a new servicer, the lender must provide notice to the insurance company of the identity of the new servicer no later than 60 days after the effective date of such a change.

43. Would a RESPA Notice of Transfer sent to the Director of FEMA (or the Director's designee) satisfy the regulatory provisions of the Act?

Answer: Yes. The delivery of a copy of the Notice of Transfer or any other form of notice is sufficient if the sender includes, on or with the notice, the following information that FEMA has indicated is needed by its designee:

- Borrower's full name;
- Flood insurance policy number;
- Property address (including city and state);
- Name of lender or servicer making notification;
- Name and address of new servicer; and
- Name and telephone number of contact person at new servicer.

44. Can delivery of the notice be made electronically, including batch transmissions?

Answer: Yes. The Regulation specifically permits transmission by electronic means. A timely batch transmission of the notice would also be permissible, if it is acceptable to the Director's designee.

45. If the loan and its servicing rights are sold by the lender, is the lender required to provide notice to the Director or the Director's designee?

Answer: Yes. Failure to provide such notice would defeat the purpose of the notice requirement because FEMA would have no record of
the identity of either the owner or servicer of the loan.

46. Is a lender required to provide notice when the servicer, not the lender, sells or transfers the *servicing rights to another servicer?*

Answer: No. After servicing rights are sold or transferred, subsequent notification obligations are the responsibility of the new servicer. The obligation of the lender to notify the Director or the Director's designee of the identity of the servicer transfers to the new servicer. The duty to notify the Director or the Director's designee of any subsequent sale or transfer of the servicing rights and responsibilities belongs to that servicer. For example, a financial institution makes and services the loan. It then sells the loan in the secondary market and also sells the servicing rights to a mortgage company. The financial institution notifies the Director's designee of the identity of the new servicer and the other information requested by FEMA so that flood insurance transactions can be properly administered by the Director's designee. If the mortgage company later sells the servicing rights to another firm, the mortgage company, not the financial institution, is responsible for notifying the Director's designee of the identity of the new servicer.

47. In the event of a merger of one lending institution with another, what are the responsibilities of the parties for notifying the Director's designee?

Answer: If an institution is acquired by or merges with another institution, the duty to provide notice for the loans being serviced by the acquired institution will fall to the successor institution in the event that notification is not provided by the acquired institution prior to the effective date of the acquisition or merger.

X. Escrow Requirements

48. Are multi-family buildings or mixed-use properties included in the definition of ``residential improved real estate'' under the Regulation for which escrows are required?

Answer: ``Residential improved real estate'' is defined under the Regulation as ``real estate upon which a home or other residential building is located or to be located.'' A loan secured by residential improved real estate located or to be located in an SFHA in which flood insurance is available is a [[**Page** 15275]] designated loan. Lenders are required to escrow flood insurance premiums and fees for any mandatory flood insurance for such loans if the lender requires the escrow of taxes, hazard insurance premiums or other loan charges for loans secured by residential improved real estate.

Multi-family buildings. For the purposes of the Act and the Regulation, the definition of residential improved real estate does not make a distinction between whether a building is single- or multi-family, or whether a building is owner- or renter-occupied. The preamble to the Regulation indicates that single-family dwellings (including mobile homes), two-to-four family dwellings, and multi-family properties containing five or more residential units are covered under the Act's escrow provisions. If the building securing the loan meets the Regulation's definition of residential improved real estate, and the lender requires the escrow of other items, such as taxes or hazard insurance premiums, then the lender is required to also escrow premiums and fees for flood insurance.

Mixed-use properties. The lender should look to the primary use of a building to determine whether it meets the definition of ``residential improved real estate.'' For example, a building having a retail store on the ground level with a small upstairs apartment used by the store's owner generally is considered a commercial enterprise and consequently would not constitute a residential building under the definition. If the primary use of a mixed-use property is for residential purposes, the Regulation's escrow requirements apply. (See Questions 8 and 9 for examples of residential and nonresidential buildings.)

49. When must escrow accounts be established for flood insurance purposes?

Answer: Lenders should look to the definition of ``federally related mortgage loan'' contained in the Real Estate Settlement Procedures Act (RESPA) to see whether a particular loan is subject to Section 10. Generally, for flood insurance purposes, only loans on one-to-four family dwellings will be subject to the escrow requirements of RESPA. (This includes individual units of condominiums. Individual units of cooperatives, although covered by Section 10 of RESPA, are not insured for flood insurance purposes.)

Loans on multi-family dwellings with five or more units are not covered by RESPA requirements. Pursuant to the Regulation, however, lenders must escrow premiums and fees for any required flood insurance if the lender requires escrows for other purposes, such as hazard insurance or taxes. This requirement pertains to any loan, including those subject to RESPA. The preceding paragraph addresses the requirement for administering loans covered by RESPA. The preamble to the Regulation contains a more detailed discussion of the escrow requirements.

50. Do voluntary escrow accounts established at the request of the borrower trigger a requirement for the lender to escrow premiums for required flood insurance?

Answer: No. If escrow accounts for other purposes are established at the voluntary request of the borrower, the lender is not required to establish escrow accounts for flood insurance premiums. Examiners should review the loan policies of the lender and the underlying legal obligation between the parties to the loan to determine whether the accounts are, in fact, voluntary. For example, when a lender's loan policies require borrowers to establish escrow accounts for other purposes and the contractual obligation permits the lender to establish escrow accounts for those other purposes, the lender will have the burden of demonstrating that an existing escrow was made pursuant to a voluntary request by the borrower.

51. Will premiums paid for credit life insurance, disability insurance, or similar insurance programs be viewed as escrow accounts requiring the escrow of flood insurance premiums?

Answer: No. Premiums paid for these types of insurance policies will not trigger the escrow requirement for flood insurance premiums.

52. Will escrow-type accounts for commercial loans, secured by multi-family residential buildings, trigger the escrow requirement for flood insurance premiums?

Answer: It depends. Escrow-type accounts established in connection with the underlying agreement between the buyer and seller, or that relate to the commercial venture itself, such as ``interest reserve accounts,'' ``compensating balance accounts,'' ``marketing accounts,'' and similar accounts are not the type of accounts that constitute escrow accounts for the purpose of the Regulation. However, escrow accounts established for the protection of the property, such as escrows for hazard insurance premiums or local real estate taxes, are the types of escrow accounts that trigger the requirement to escrow flood insurance premiums.

53. What requirements for escrow accounts apply to properties covered by RCBAPs?

Answer: RCBAPs are policies purchased by the condominium association on behalf of itself and the individual unit owners in the condominium. A portion of the periodic dues paid to the association by the condominium owners applies to the premiums on the policy. When a lender makes a loan for the purchase of a condominium unit and when dues to the condominium association apply to the RCBAP premiums, an escrow account is not required. Lenders should exercise due diligence with respect to continuing compliance with the insurance requirements on the part of the condominium association.

XI. Forced Placement of Flood Insurance

54. What is the requirement for the forced placement of flood insurance under the Act and Regulation?

Answer: The Act and Regulation require a lender to force place flood insurance, if all of the following circumstances occur:

- The lender determines at any time during the life of the loan that the property securing the loan is located in an SFHA;
- The community in which the property is located participates in the NFIP;
- The lender determines that flood insurance coverage is inadequate or does not exist; and
- After required notice, the borrower fails to purchase the appropriate amount of coverage.

A lender must notify the borrower of the required amount of flood insurance that must be obtained within 45 days after notification. The notice to the borrower must also state that if the borrower does not obtain the insurance within the 45-day period, the lender will purchase the insurance on behalf of the borrower and may charge the borrower the cost of premiums and fees to obtain the coverage. If adequate insurance is not obtained within the 45-day period, then the insurance must be force placed. Standard Fannie Mae/Freddie Mac documents permit the servicer or lender to add those charges to the principal amount of the loan.

FEMA developed the Mortgage Portfolio Protection Program (MPPP) to assist lenders in connection with forced placement procedures. FEMA published these procedures in the Federal Register on August 29, 1995 (60 FR 44881). Appendix A of the FEMA publication contains examples of notification letters to be used in connection with the MPPP.

55. Can a servicer force place on behalf of a lender?

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Answer: Yes. Assuming the statutory prerequisites for forced placement are met, and subject to the servicing contract between the lender and the servicer, the Act clearly authorizes servicers to force place flood insurance on behalf of the lender, following the procedures set forth in the Regulation.

56. When forced placement occurs, what is the amount of insurance required to be placed?

Answer: The amount of flood insurance coverage required is the same regardless of how the insurance is placed. (See Section II. Determining the appropriate amount of flood insurance required under the Act and Regulation.)

XII. Gap Insurance Policies

57. May a lender rely on a gap or blanket insurance policy to meet its obligation to ensure that its designated loans are covered by an adequate amount of flood insurance over the life of the loans?

Answer: Generally no. Gap or blanket insurance typically is not an adequate substitute for NFIP insurance. Among other things, a gap or
blanket policy typically protects only the lender's, not the borrower's, interest and, therefore, may not be transferred when a loan is sold. The presence of a gap or blanket policy may serve as a disincentive for the lender or its servicer to perform its due diligence and ensure that there is adequate coverage for a designated loan. Finally, a lender that substitutes a gap or blanket policy for an individual flood insurance policy would be unable to sell the loan in the secondary market, since Fannie Mae and Freddie Mac will not accept loans that are covered solely by a gap or blanket policy.

In limited circumstances, a gap or blanket policy may satisfy a lender's flood insurance obligations, when NFIP and private insurance is otherwise unavailable. For example, when a designated loan does not have sufficient coverage, but the borrower refuses to increase coverage under his NFIP insurance, a gap or blanket policy may be appropriate when the lender is unable to force-place private insurance for some reason. Similarly, when a policy has expired, and the borrower has failed to renew coverage, gap or blanket coverage may be adequate protection for the lender for the 15-day gap in coverage between the end of the 30-day ``grace'' period after the NFIP policy expiration and the end of the 45-day force placement notice period. However, the lender must force place adequate coverage in a timely manner, as required, and may not rely on the gap or blanket coverage on an on-going basis.

XIII. Required Use of Standard Flood Hazard Determination Form (SFHDF)

58. Does the SFHDF replace the borrower notification form?

Answer: No. The notification form is used to notify the borrower(s) that he or she is purchasing improved property located in an SFHA. The
financial regulatory Agencies, in consultation with FEMA, included a revised version of the sample borrower notification form in Appendix A
to the Regulation. The SFHDF is used by the lender to determine whether the property securing the loan is located in an SFHA.

59. Is the lender required to provide the SFHDF to the borrower?

Answer: No. While it may be a common practice in some areas for lenders to provide a copy of the SFHDF to the borrower to give to the
insurance agent, lenders are neither required nor prohibited from providing the borrower with a copy of the form. In the event a lender
does provide the SFHDF to the borrower, the signature of the borrower is not required to acknowledge receipt of the form.

60. May the SFHDF be used in electronic format?

Answer: Yes. FEMA, in the final rule adopting the SFHDF stated: ``If an electronic format is used, the format and exact layout of the
Standard Flood Hazard Determination Form is not required, but the fields and elements listed on the form are required. Any electronic
format used by lenders must contain all mandatory fields indicated on the form.'' It should be noted,

however, that the lender must be able
to reproduce the form upon receiving a document request by its federal supervisory agency.

61. Section 528 of the Act, 42 U.S.C. 4104b(e), permits a lender to rely on a previous flood determination using the SFHDF when it is increasing, extending, renewing or purchasing a loan secured by a building or a mobile home. Under the Act, the ``making'' of a loan is not listed as a permissible event that permits a lender to rely on a previous determination. May a lender rely on a previous determination for a refinancing or assumption of a loan?

Answer: It depends. When the loan involves a refinancing or assumption by the same lender who obtained the original flood determination on the same property, the lender may rely on the previous determination only if the original determination was made not more than seven years before the date of the transaction, the basis for the determination was set forth on the SFHDF, and there were no map revisions or updates affecting the security property since the original determination was made. A loan refinancing or assumption made by a lender different from the one who obtained the original determination constitutes a new loan, thereby requiring a new determination.

XIV. Flood Determination Fees

62. When can lenders or servicers charge the borrower a fee for making a determination?

Answer: There are four instances under the Act and Regulation when the borrower can be charged a specific fee for a flood determination:

- When the determination is made in connection with the making, increasing, extending, or renewing of a loan that is initiated by the borrower;
- When the determination is prompted by a revision or updating by FEMA of floodplain areas or flood-risk zones;
- When the determination is prompted by FEMA's publication of notices or compendia that affect the area in which the security property is located; or
- When the determination results in forced placement of insurance.

Loan or other contractual documents between the parties may also permit the imposition of fees.

63. May charges made for life of loan reviews by flood determination firms be passed along to the borrower?

Answer: Yes. In addition to the initial determination at the time a loan is made, increased, renewed, or extended, many flood determination
firms provide a service to the lender to review and report changes in the flood status of a dwelling for the entire term of the loan. The fee
charged for the service at loan closing is a composite one for conducting both the original and subsequent reviews. Charging a fee for
the original determination is clearly within the permissible purpose envisioned by the Act. The Agencies agree that a determination fee may
include, among other things, reasonable fees for a lender, servicer, or third party to monitor the flood hazard status of property securing a
loan in order to make determinations on an ongoing basis.

However, the life-of-loan fee is based on the authority to charge a determination fee and, therefore, the

monitoring fee may be charged
only if the events specified in the answer to Question 62 occur.

XV. Flood Zone Discrepancies

*64. What should a lender do when there is a discrepancy between the flood hazard zone designation on the flood [[**Page** 15277]] determination form and the flood insurance policy?*

Answer: Lenders should have a process in place to identify and resolve such discrepancies. In attempting to resolve a particular discrepancy, a lender should determine whether there may be a legitimate reason for a discrepancy.

The flood determination form designates a flood hazard zone where the building or mobile home is actually located based on the latest FEMA information; the flood insurance policy designates the flood hazard zone for purposes of rating the degree of flood hazard risk. The two respective flood hazard zone designations may legitimately differ by virtue of the NFIP's ``Grandfather Rule,'' which provides for the continued use of a rating on an insured property when the initial flood insurance policy was issued prior to changes in the hazard rating for the particular flood zone where the property is located. The Grandfather Rule allows policyholders who have maintained continuous coverage and/or who have built in compliance with the Flood Insurance Rate Map to continue to benefit from the prior, more favorable rating for particular pieces of improved property. A discrepancy caused as a result of the application of the NFIP's Grandfather Rule is reasonable and acceptable. In such an event where the lender determines that there is a legitimate reason for the discrepancy, it should document its findings.

If the lender is unable to reconcile a discrepancy between the flood hazard zone designation on the flood determination form and the flood insurance policy and there is no legitimate reason for the discrepancy, the lender and borrower may jointly request that FEMA review the determination. This procedure is intended to confirm or disprove the accuracy of the original determination. The procedures for initiating a FEMA review are found at 44 CFR 65.17. This request must be submitted within 45 days of the lender's notification to the borrower of the requirement to obtain flood insurance.

65. Can a lender be found in violation of the requirements of federal flood insurance regulations if, despite the lender's diligence in making the flood hazard determination, notifying the borrower of the risk of flood and the need to obtain flood insurance, and requiring mandatory flood insurance, there is a discrepancy between the flood hazard zone designation on the flood determination form and the flood insurance policy?

Answer: Yes. As noted in Question 64 above, lenders should have a process in place to identify and resolve such discrepancies. If a lender is able to resolve a discrepancy--either by finding a legitimate reason for such discrepancy or by attempting to resolve the discrepancy by contacting FEMA to review the determination, then no violation will be cited. However, if more than occasional, isolated instances of unresolved discrepancies are found in a lender's loan portfolio, the Agencies may cite the lender for a violation of the mandatory purchase requirements. Failure to resolve such discrepancies could result in the lender's collateral not being covered by the amount of legally required flood insurance.

XVI. Notice of Special Flood Hazards and Availability of Federal Disaster Relief

66. Does the notice have to be provided to each borrower for a real estate related loan?

Answer: No. In a transaction involving multiple borrowers, the lender need only provide the notice to any one of the borrowers in the transaction. Lenders may provide multiple notices if they choose. The lender and borrower(s) typically designate the borrower to whom the notice will be provided. The notice must be provided to a borrower when the lender determines that the property securing the loan is or will be located in an SFHA.

67. Lenders making loans on mobile homes may not always know where the home is to be located until just prior to, or sometimes after, the time of loan closing. How is the notice requirement applied in these situations?

Answer: When it is not reasonably feasible to give notice before the completion of the transaction, the notice requirement can be met by lenders in mobile home loan transactions if notice is provided to the borrower as soon as practicable after determination that the mobile home will be located in an SFHA. Whenever time constraints can be anticipated, regulated lenders should use their best efforts to provide adequate notice of flood hazards to borrowers at the earliest possible time. In the case of loan transactions secured by mobile homes not located on a permanent foundation, the Agencies note that such ``home only'' transactions are excluded from the definition of mobile home and the notice requirements would not apply to these transactions.

However, as indicated in the preamble to the Regulation, the Agencies encourage a lender to advise the borrower that if the mobile home is later located on a permanent foundation in an SFHA, flood insurance will be required. If the lender, when notified of the location of the mobile home subsequent to the loan closing, determines that it has been placed on a permanent foundation and is located in an SFHA in which flood insurance is available under the Act, flood insurance coverage becomes mandatory and appropriate notice must be given to the borrower under those provisions. If the borrower fails to purchase flood insurance coverage within 45 days after notification, the lender must force place the insurance.

68. When is the lender required to provide notice to the servicer of a loan that flood insurance is required?

Answer: Because the servicer of a loan is often not identified prior to the closing of a loan, the Regulation requires that notice be provided no later than the time the lender transmits other loan data, such as information concerning hazard insurance and taxes, to the servicer.

69. What will constitute appropriate form of notice to the servicer?

Answer: Delivery to the servicer of a copy of the notice given to the borrower is appropriate notice. The Regulation also provides that the notice can be made either electronically or by a written copy.

70. In the case of a servicer affiliated with the lender, is it necessary to provide the notice?

Answer: Yes. The Act requires the lender to notify the servicer of special flood hazards and the Regulation reflects this requirement. Neither contains an exception for affiliates.

71. How long does the lender have to maintain the record of receipt by the borrower of the notice?

Answer: The record of receipt provided by the borrower must be maintained for the time that the lender owns the loan. Lenders may keep
the record in the form that best suits the lender's business practices. Lenders may retain the record electronically, but they must be able to

retrieve the record within a reasonable time pursuant to a document request from their federal supervisory agency.

72. Can a lender rely on a previous notice if it is less than seven years old and it is the same property, same borrower, and same lender?

Answer: No. The preamble to the Regulation states that subsequent transactions by the same lender with respect to the same property will be treated as a renewal and will require no new determination. However, neither the Regulation nor the preamble addresses waiving the requirement to [[**Page** 15278]] provide the notice to the borrower. Therefore, the lender must provide a new notice to the borrower, even if a new determination is not required.

73. Is use of the sample form of notice mandatory?

Answer: No. Although lenders are required to provide a notice to a borrower when it makes, increases, extends, or renews a loan secured by an improved structure located in an SFHA, use of the sample form of notice provided in Appendix A is not mandatory. It should be noted that the sample form includes other information in addition to what is required by the Act and the Regulation. Lenders may personalize, change the format of, and add information to the sample form of notice, if they choose. However, a lender-revised notice must provide the borrower with at least the minimum information required by the Act and Regulation. Therefore, lenders should consult the Act and Regulation to determine the information needed.

XVII. Mandatory Civil Money Penalties

74. What violations of the Act can result in a mandatory civil money penalty?

Answer: A pattern or practice of violations of any of the following requirements of the Act and their implementing Regulations triggers a mandatory civil money penalty:

(i) Purchase of flood insurance where available (42 U.S.C. 4012a(b));
(ii) Escrow of flood insurance premiums (42 U.S.C. 4012a(d));
(iii) Forced placement of flood insurance (42 U.S.C. 4012a(e));
(iv) Notice of special flood hazards and the availability of Federal disaster relief assistance (42 U.S.C. 4104a(a)); and
(v) Notice of servicer and any change of servicer (42 U.S.C. 4101a(b)).

The Act states that any regulated lending institution found to have a pattern or practice of certain violations ``shall be assessed a civil penalty'' by its Federal supervisor in an amount not to exceed $350 per violation, with a ceiling per institution of $100,000 during any calendar year (42 U.S.C. 4012a(f)(5)). This limit has since been raised to $385 per violation, and the annual ceiling to $125,000 pursuant to the Federal Civil Penalties Inflation Adjustment Act of 1990, as amended by the Debt Collection Improvement Act of 1996, 28 U.S.C. 2461 note. Lenders pay the penalties into the National Flood Mitigation Fund held by the Department of the Treasury for the benefit of FEMA.

75. What constitutes a ``pattern or practice'' of violations for which civil money penalties must be imposed under the Act?

Answer: The Act does not define ``pattern or practice.'' The Agencies make a determination of whether one exists by weighing the individual facts and circumstances of each case. In making the determination, the Agencies look both to guidance and experience with determinations of pattern or practice under other regulations (such as Regulation B (Equal Credit Opportunity) and Regulation Z (Truth in Lending)), as well as Agencies' precedents in assessing civil money penalties for flood insurance violations.

The *Policy Statement on Discrimination in Lending* (Policy Statement) provided the following guidance on what constitutes a pattern or practice:

> Isolated, unrelated, or accidental occurrences will not constitute a pattern or practice. However, repeated, intentional, regular, usual, deliberate, or institutionalized practices will almost always constitute a pattern or practice. The totality of the circumstances must be considered when assessing whether a pattern or practice is present.

In determining whether a financial institution has engaged in a pattern or practice of flood insurance violations, the Agencies' considerations may include, but are not limited to, the presence of one or more of the following factors:

- Whether the conduct resulted from a common cause or source within the financial institution's control;
- Whether the conduct appears to be grounded in a written or unwritten policy or established practice;
- Whether the noncompliance occurred over an extended period of time;
- The relationship of the instances of noncompliance to one another (for example, whether the instances of noncompliance occurred in the same area of a financial institution's operations);
- Whether the number of instances of noncompliance is significant relative to the total number of applicable transactions. (Depending on the circumstances, however, violations that involve only a small percentage of an institution's total activity could constitute a pattern or practice);
- Whether a financial institution was cited for violations of the Act and Regulation at prior examinations and the steps taken by the financial institution to correct the identified deficiencies;
- Whether a financial institution's internal and/or external audit process had not identified and addressed deficiencies in its flood insurance compliance; and
- Whether the financial institution lacks generally effective flood insurance compliance policies and procedures and/or a training program for its employees.

Although these guidelines and considerations are not dispositive of a final resolution, they do serve as a reference point in assessing whether there may be a pattern or practice of violations of the Act and Regulation in a particular case. As previously stated, the presence or absence of one or more of these considerations may not eliminate a finding that a pattern or practice exists.

End of text of the Interagency Questions and Answers Regarding Flood Insurance.

Dated: March 5, 2008.
John C. Dugan,
Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, March 12, 2008.
Jennifer J. Johnson,
Secretary of the Board.

Dated at Washington, DC, this 14th day of March, 2008.
Federal Deposit Insurance Corporation.
Valerie J. Best,
Assistant Executive Secretary.

Dated: February 5, 2008.
By the Office of Thrift Supervision.
John M. Reich,
Director.

Dated: March 13, 2008.
Roland E Smith,
Secretary, Farm Credit Administration Board.

By the National Credit Union Administration Board, on March 13, 2008.
Mary F. Rupp,
Secretary of the Board.

74 FR 35914, 07/21/2009

Handbook Mailing HM-09-6

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket ID OCC 2009-0014]

FEDERAL RESERVE SYSTEM

[Docket No. R-1311]

FEDERAL DEPOSIT INSURANCE CORPORATION

RIN 3064-ZA00

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[Docket ID OTS-2009-0005]

FARM CREDIT ADMINISTRATION

RIN 3052-AC46

NATIONAL CREDIT UNION ADMINISTRATION

RIN 3133-AD41

Loans in Areas Having Special Flood Hazards; Interagency Questions and Answers Regarding Flood Insurance

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); Farm Credit Administration (FCA); National Credit Union Administration (NCUA).

ACTION: Notice and request for comment.

SUMMARY: The OCC, Board, FDIC, OTS, FCA, and NCUA (collectively, the Agencies) are issuing final revisions to the Interagency Questions and Answers Regarding Flood Insurance (Interagency Questions and Answers). The Agencies are also soliciting comments on proposed revisions to the Interagency Questions and Answers. To help financial institutions meet
their responsibilities under Federal flood insurance legislation and to increase public understanding of the

flood insurance regulation, the Agencies are finalizing new and revised guidance, as well as proposing new and revised guidance that address the most frequently asked questions about flood insurance. The revised Interagency Questions and Answers contain staff guidance for agency personnel, financial institutions, and the public.

DATES: Effective date: September 21, 2009. Comment due date: Comments on the proposed questions and answers must be submitted on or before September 21, 2009.

ADDRESSES: OCC: Because paper mail in the Washington, DC area and at the Agencies is subject to delay, commenters are encouraged to submit comments by e-mail, if possible. Please use the title ``Loans in Areas Having Special Flood Hazards; Interagency Questions and Answers Regarding Flood Insurance'' to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

E-mail: regs.comments@occ.treas.gov.

Mail: Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.

Fax: (202) 874-5274.

Hand Delivery/Courier: 250 E Street, SW., Attn: Communications Division, Mail Stop 2-3, Washington, DC 20219.

Instructions: You must include ``OCC'' as the agency name and ``Docket Number OCC-2009-0014'' in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this notice by any of the following methods:

Viewing Comments Personally: You may personally inspect and photocopy comments at the OCC's Communications Division, 250 E Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling in advance (202) 874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.

Docket: You may also view or request available background documents and project summaries using the methods described above.

Board: You may submit comments, identified by Docket No. R-1311, by any of the following methods:

Agency Web Site: http://www.federalreserve.gov. Follow the instructions for

submitting comments at
http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.

Federal eRulemaking Portal: http://www.Regulation.gov.

Follow the instructions for submitting comments.

E-mail: regs.comments@federalreserve.gov. Include docket number in the subject line of the message.

Fax: (202) 452-3819 or (202) 452-3102.

Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information.

Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

FDIC: You may submit comments, identified by RIN number 3064-ZA00 by any of the following methods:

Agency Web Site: http://www.fdic.gov/Regulation/laws/federal/propose.html. Follow instructions for submitting comments on the ``Agency Web Site.''

E-mail: Comments@FDIC.gov. Include the RIN number in the subject line of the message.

Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

Hand Delivery/Courier: Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

Instructions: All submissions received must include the agency name and RIN number. All comments received will be posted without change to http://www.fdic.gov/Regulation/laws/federal/propose.html including any personal information provided.

OTS: You may submit comments, identified by OTS-2009-0005, by any of the following methods:

E-mail: regs.comments@ots.treas.gov. Please include ID OTS-2009-0005 in the subject line of the message and include your name and telephone number in the message.

Fax: (202) 906-6518.

Mail: Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: OTS-2009-0005.

Hand Delivery/Courier: Guard's Desk, East Lobby Entrance, 1700 G [[Page 35915]] Street, NW., from 9 a.m. to 4 p.m. on business days, Attention: Regulation Comments, Chief Counsel's Office, Attention: OTS-2009-0005.

Instructions: All submissions received must include the agency name and docket number for this rulemaking. All comments received will be posted without change, including any personal information provided. Comments, including attachments and other supporting materials received are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

Viewing Comments Electronically: OTS will post comments on the OTS Internet Site at http://www.ots.treas.gov/?p=opencomment1.

Viewing Comments On-Site: You may inspect comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906-6518. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10 a.m. and 4 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

FCA: We offer a variety of methods for you to submit comments. For accuracy and efficiency reasons, we encourage commenters to submit comments by e-mail or through the Agency's Web site or the Federal eRulemaking Portal. You may also send comments by mail or by facsimile transmission. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

E-mail: Send us an e-mail at reg-comm@fca.gov.

Agency Web Site: http://www.fca.gov. Once you are at the Web site, select ``Legal Info,'' then ``Pending Regulation and Notices.''

Federal eRulemaking Portal: http://www.Regulation.gov. Follow the instructions for submitting comments.

Mail: Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

Fax: (703) 883-4477. Posting and processing of faxes may be delayed. Please consider another means to comment, if possible.

You may review copies of comments we receive at our office in McLean, Virginia, or from our Web site at http://www.fca.gov. Once you are in the Web site, select ``Legal

Info,'' and then select ``Public Comments.'' We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

NCUA: You may submit comments by any of the following methods (Please send comments by one method only):

Federal eRulemaking Portal: http://www.Regulation.gov. Follow the instructions for submitting comments.

NCUA Web Site: http://www.ncua.gov/RegulationOpinionsLaws/proposed_regs/proposed_regs.html. Follow the instructions for submitting comments.

E-mail: Address to regcomments@ncua.gov. Include ``[Your name] Comments on Flood Insurance, Interagency Questions & Answers'' in the e-mail subject line.

Fax: (703) 518-6319. Use the subject line described above for e-mail.

Mail: Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.

Hand Delivery/Courier: Same as mail address.

Public Inspection: All public comments are available on the agency's Web site at http://www.ncua.gov/RegulationOpinionsLaws/comments as submitted, except as may not be possible for technical reasons. Public comments will not be edited to remove any identifying or contact information. Paper copies of comments may be inspected in NCUA's law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment weekdays between 9 a.m. and 3 p.m. To make an appointment, call (703) 518-6546 or send an e-mail to OGCMail@ncua.gov.

FOR FURTHER INFORMATION CONTACT:

OCC: Pamela Mount, National Bank Examiner, Compliance Policy, (202) 874-4428; or Margaret Hesse, Special Counsel, Community and Consumer Law Division, (202) 874-5750, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

Board: Vivian Wong, Senior Attorney, Division of Consumer and Community Affairs, (202) 452-2412; Tracy Anderson, Senior Supervisory Consumer Financial Services Analyst (202) 736-1921; or Brad Fleetwood, Senior Counsel, Legal Division, (202) 452-3721, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW.,
Washington, DC 20551. For the deaf, hard of hearing, and speech impaired only, teletypewriter (TTY), (202) 263-4869.

FDIC: Mira N. Marshall, Chief, Compliance Policy Section, Division of Supervision and Consumer Protection, (202) 898-3912; or Mark Mellon, Counsel, Legal Division, (202) 898-3884, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429. For the hearing impaired only, telecommunications device for the deaf TDD: 800-925-4618.

OTS: Ekita Mitchell, Consumer Regulation Analyst, (202) 906-6451; or Richard S. Bennett, Senior Compliance Counsel, (202) 906-7409, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

FCA: Mark L. Johansen, Senior Policy Analyst, Office of Regulatory Policy, (703) 883-4498; or Mary Alice Donner, Attorney Advisor, Office of General Counsel, (703) 883-4033, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090. For the hearing impaired only, TDD (703) 883-4444.

NCUA: Justin M. Anderson, Staff Attorney, Office of General Counsel, (703) 518-6540; or Pamela Yu, Staff Attorney, Office of General Counsel, (703) 518-6593, National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314-3428.

SUPPLEMENTARY INFORMATION:

Background

The National Flood Insurance Reform Act of 1994 (the Reform Act) (Title V of the Riegle Community Development and Regulatory Improvement Act of 1994) comprehensively revised the two Federal flood insurance statutes, the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973. The Reform Act required the OCC, Board, FDIC, OTS, and NCUA to revise their flood insurance regulations and required the FCA to promulgate a flood insurance regulation for the first time. The OCC, Board, FDIC, OTS, NCUA, and FCA (collectively, ``the Agencies'') fulfilled these requirements by issuing a joint final rule in the summer of 1996. See 61 FR 45684 (August 29, 1996).

In connection with the 1996 joint rulemaking process, the Agencies received a number of requests to clarify specific issues covering a wide spectrum of the proposed rule's provisions. The Agencies addressed many of these requests in the preamble to the joint final rule. The Agencies concluded, however, that given the [[Page 35916]] number, level of detail, and diversity of the requests, guidance addressing the technical compliance issues would be helpful and appropriate. Consequently, the Agencies decided to issue guidance to address these technical issues subsequent to the promulgation of the final rule (61 FR at 45685-86). The Federal Financial Institutions Examination Council (FFIEC) fulfilled that objective through the initial release of the Interagency Questions and Answers in 1997 (1997 Interagency Questions and Answers). 62 FR 39523 (July 23, 1997).

In response to issues that had been raised, the Agencies, in coordination with the Federal Emergency Management Agency (FEMA), released for public comment proposed revisions to the 1997 Interagency Questions and Answers. 73 FR 15259 (March 21, 2008) (March 2008 Proposed Interagency Questions and Answers). Among the changes the Agencies proposed were the introduction of new questions and answers in a number of areas, including second lien mortgages, the imposition of civil money penalties, and loan syndications/participations. The Agencies also proposed substantive modifications to questions and answers previously adopted in the 1997 Interagency Questions and Answers pertaining to construction loans and condominiums. Finally, the Agencies proposed to revise and reorganize certain of the existing questions and answers to clarify areas of potential misunderstanding and to provide clearer guidance to users.

The Agencies received and considered comments from 59 public commenters, and are now adopting the Interagency Questions and Answers, comprising 77 questions and answers, revised as appropriate based on comments received. The Agencies made nonsubstantive revisions to certain answers upon further consideration either to more directly respond to the question asked or to provide additional clarity. The Agencies are also proposing five new questions and answers for public comment. These Interagency Questions and Answers supersede the 1997 Interagency Questions and Answers and supplement other guidance or interpretations issued by the Agencies and FEMA.

For ease of reference, the following terms are used throughout this document: ``Act'' refers to the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973, as revised by the National Flood Insurance Reform Act of 1994 (codified at 42 U.S.C. 4001 et seq.). ``Regulation'' refers to each agency's current final flood insurance rule.\1\

\1\ The Agencies' rules are codified at 12 CFR part 22 (OCC), 12 CFR part 208 (Board), 12 CFR part 339 (FDIC), 12 CFR part 572 (OTS), 12 CFR part 614 (FCA), and 12 CFR part 760 (NCUA).

Section-by-Section Analysis

Section I. Determining When Certain Loans Are Designated Loans for Which Flood Insurance Is Required Under the Act and Regulation

The Agencies proposed this new section to address specific circumstances a lender may encounter when deciding whether a loan should be a designated loan for purposes of flood insurance. The proposed new section was intended to replace the previous section I in the 1997 Interagency Questions and Answers entitled ``Definitions'' and to incorporate existing questions from other sections addressing this topic and two new questions.

Proposed question and answer 1 addressed the applicability of the Regulation to loans made in a nonparticipating community. One commenter suggested the Agencies mention that a lender may choose to require private flood insurance per its loan agreement with the borrower, for buildings or mobile homes located outside a community in the National Flood Insurance Program (NFIP). The Agencies agree that lenders have such discretion, but do not believe that the question and answer requires further elaboration. Another commenter suggested the Agencies mention that Government Sponsored Enterprises (GSEs), such as Fannie Mae and Freddie Mac, may not purchase loans made on properties in a Special Flood Hazard Area (SFHA) in communities that do not participate in the NFIP. The Act does require GSEs to have procedures in place to ensure that purchased loans are in compliance with the mandatory purchase requirements. The

Agencies do not believe that further elaboration is necessary and adopt the question and answer as proposed.

Proposed question and answer 2 explained that, upon a FEMA map change that results in a building or mobile home securing a loan being removed from an SFHA, a lender is no longer obligated to require mandatory flood insurance. However, the lender may choose to continue to require flood insurance for risk management purposes. The Agencies received one comment from an industry group suggesting the guidance in proposed question and answer 2 be amended to add language encouraging lenders to promptly remove the flood insurance requirement from a loan when the building or mobile home securing the loan is removed from an SFHA by way of a map change. The decision to require flood insurance in these instances is typically made on a case-by-case basis, depending on a lender's risk management practices. The Agencies do not believe that a blanket statement encouraging lenders to remove flood insurance in such instances is an appropriate position; therefore, the question and answer is adopted as proposed.

Proposed question and answer 3 addressed whether a lender's purchase of a loan, secured by a mobile home or building located in an SFHA in which flood insurance is available under the Act, from another lender triggers any requirements under the Regulation. The Agencies received several comments opposing the reference to safety and soundness necessitating a due diligence review prior to purchasing the loan. The Agencies note that although lenders are not required to review loans for flood insurance compliance prior to purchase, depending upon the circumstances, safety and soundness considerations may sometimes necessitate such due diligence. As such, the Agencies do not concur with the commenter's opposition and adopt question and answer 3 as proposed.

The Agencies are adopting a new question and answer 4 addressing syndicated and participation loans following question and answer 3, which deals with purchased loans, to emphasize the need for similar treatment of purchased loans and syndicated and participation loans. The new question and answer was initially proposed as question and answer 40 under section VIII. Proposed section VIII on loan syndications and participations and the accompanying question and answer are removed and the remaining sections are renumbered accordingly.

Proposed question and answer 40 explained that, with respect to loan syndications and participations, individual participating lenders are responsible for ensuring compliance with flood insurance requirements. The proposed answer further explained that participating lenders may fulfill this obligation by performing upfront due diligence to ensure that the lead lender or agent has undertaken the necessary activities to make sure that appropriate flood insurance is obtained and has adequate controls to monitor the loan(s) on an on-going basis.

The Agencies received several comments from financial institutions and industry trade groups opposing the [[Page 35917]] differences between the guidance in proposed question and answer 3 regarding the purchase of a loan and the guidance in proposed question and answer 40. A majority of the commenters argued that loan participations and syndications should be treated the same as other loan purchases for purposes of flood insurance. Several of these commenters suggested that the Agencies' proposed treatment of loan syndications and participations appeared to be inconsistent with proposed question and answer 3 pertaining to purchased loans.

In response to these comments, the Agencies are revising the relevant question and answer to reflect that, as with purchased loans, the acquisition by a lender of an interest in a loan either by participation or syndication, after that loan has been made, does not trigger the requirements of the Act and Regulation, such as making a new flood determination or requiring a borrower to purchase flood insurance. Nonetheless, as with purchased loans, depending upon the circumstances, safety and soundness considerations may sometimes necessitate that the lender undertake due diligence to protect itself against the risk of flood or other types of loss.

If a regulated lender is involved in the making of the underlying loan, but does not purchase a loan participation or syndication after the loan has been made, the flood requirements of the Act and Regulation would apply to the lender. The Agencies believe that lenders who pool or contribute funds that will be advanced simultaneously to a borrower as a loan secured by improved real estate would all be considered to have ``made'' the loan under the Act and Regulation. In such circumstances, each participating lender in a loan participation or syndication is responsible for compliance with the Act and Regulation. This does not mean that each participating lender must separately obtain a flood determination or monitor whether flood insurance premiums are paid. Rather, it means that each participating lender subject to Federal flood insurance requirements should perform upfront due diligence to ensure both that the lead lender or agent has undertaken the necessary activities to make sure that the borrower obtains appropriate flood insurance and that the lead lender or agent has adequate controls to monitor the loan(s) on an on-going basis for compliance with the flood insurance requirements. The participating lender should require as a condition to the loan-sharing agreement that the lead lender or agent will provide participating lenders with sufficient information on an ongoing basis to monitor compliance with flood insurance requirements. A written representation provided by the lead lender or syndication agent certifying that the borrower has obtained appropriate flood insurance would be sufficient. Alternatively, the lead lender or syndication agent could provide participants and syndication lenders with a copy of the declaration page or other proof of insurance. The Agencies have incorporated minor revisions to the question and answer to clarify this guidance.

Proposed question and answer 4 (final question and answer 5) addressed the applicability of the Regulation to loans being restructured because of the borrower's default on the original loan. In light of the many loan modifications being made, the Agencies have revised the question to address loan modifications as well as loans being restructured because of the borrower's default on the original loan. The guidance provided in the answer is applicable to either situation. The Agencies received one comment asking whether capitalization of a loan in the event of a default would constitute an increase in the loan, triggering the requirements of the Regulation. If the capitalization results in an increase in the outstanding principal balance of the loan, then the requirements of the Regulation will apply. Conversely, a loan restructure that does not result in an increase in the amount to the loan (or an extension of the term of the loan) will not trigger the requirements of the Regulation. The Agencies do not believe further elaboration addressing this comment is necessary. The Agencies adopt the question and answer as proposed with the changes made to include loan modifications, as well as restructuring of loans.

Proposed question and answer 5 (final question and answer 6), addressed whether table funded loans are treated as new loan originations. The Agencies did not receive any substantive comments and adopt the question and answer as proposed.

Proposed question and answer 6 (final question and answer 7) explained that a lender is not required to perform a review of its existing loan portfolio for purposes of the Act or Regulation; however,
sound risk management practices may lead a lender to conduct periodic reviews. The Agencies received several comments opposing the reference to safety and soundness necessitating a due diligence review of a lender's portfolio. Although lenders are not required to review existing loan portfolios for flood insurance compliance under the Act or Regulation, the Agencies believe safety and soundness considerations may sometimes necessitate such due diligence and therefore adopt the question and answer as proposed.

Section II. Determining the Appropriate Amount of Flood Insurance Required Under the Act and Regulation

The Agencies proposed this section to provide guidance on how lenders should determine the appropriate amount of flood insurance to require the borrower to purchase. The Agencies received numerous comments on this proposed section. As a result of these comments, the Agencies have made both significant revisions to proposed questions and answers as well as proposed new questions and answers submitted for comment to provide greater clarity on this important area. The proposed new questions and answers are addressed in the SUPPLEMENTARY INFORMATION immediately following the Redesignation Table.

Proposed question and answer 7 (final question and answer 8) addressed what is meant by the ``maximum limit of coverage available for the particular type of property under the Act.'' The first part of the question and answer discussed the maximum caps on insurance available under the Act. The Agencies did not receive any substantive comments on this part of the question and answer and adopt it as proposed in final question and answer 8. The second part of the question and answer discussed the maximum limits on the coverage in the context of the regulation that provides that ``flood insurance coverage under the Act is limited to the overall value of the property securing the designated loan minus the value of the land on which the property is located,'' commonly referred to as insurable value. In response to the numerous comments received on the insurable value part of the proposed question and answer, the Agencies are proposing new questions and answers 9 and 10 for public comment. The Agencies otherwise adopt question and answer 7 (final question and answer 8) as proposed.

Proposed questions and answers 8 and 9 (final questions and answers 11 and 12 respectively) more fully defined the terms ``residential building'' and ``nonresidential building.'' One commenter suggested that the Agencies define residential and nonresidential buildings based on the percentage of the building used in a certain way to account for mixed use buildings. [[Page 35918]]
Proposed question and answer 8 (final question and answer 11) provides that a residential building may have incidental nonresidential use as long as such incidental use is limited

to less than 25 percent of the square footage of the building. A mixed use residential building where greater than 25 percent of the square footage of the building is devoted to incidental nonresidential use will be considered a nonresidential building. Proposed question and answer 9 (final question and answer 12) provides that a mixed use nonresidential building with less than 75 percent of the square footage of the building used for residential purposes will still be considered nonresidential. The commenter also asked whether a farm house is residential or nonresidential. If the farmhouse is used as a dwelling, then it will be considered residential.

Another commenter asked whether a lender is obligated to determine the amount of nonresidential use in a residential building and whether there are any record maintenance requirements. Typically, whether a building is nonresidential or residential is of most importance in determining the maximum limits of a general property form NFIP policy. A residential building covered under a general property form will have a maximum coverage limit of $250,000, while a nonresidential building covered under the same type of policy will have a maximum coverage limit of $500,000. Therefore, the lender needs to know whether the building is considered residential or nonresidential when it determines the amount of flood insurance coverage to require. Finally, a commenter asked whether a designated loan, secured by a residential building and a detached nonresidential building, such as a garage, would require separate nonresidential coverage on the detached nonresidential building. If the residential building is a one-to-four family dwelling that is covered by a dwelling form NFIP policy, that policy will cover a detached garage at the same location as the dwelling, up to 10 percent of the limit of liability on the dwelling, so long as the detached garage is not used or held for use as a residence, a business or for farming purposes. In other cases, the lender must require the borrower to obtain coverage for each building securing the loan. The Agencies believe no further clarification is necessary and adopt the questions and answers as proposed.

Proposed question and answer 10 (final question and answer 13) illustrated how to apply the ``maximum limit of coverage available for the particular type of building under the Act.'' The majority of the comments received are addressed in the discussion below pertaining to new proposed questions and answers 9 and 10. The Agencies adopt question and answer 10 (final question and answer 13) as proposed.

Proposed questions and answers 11 and 12 (final questions and answers 14 and 15 respectively) were originally adopted in the 1997 Interagency Questions and Answers. The changes proposed by the Agencies in March 2008 were designed to provide greater clarity with no intended change in substance and meaning.

Four commenters addressed proposed question and answer 11, which dealt with flood insurance requirements where a designated loan is secured by more than one building. One commenter supported the proposed question and answer, but suggested that where the collateral is worthless and would not be replaced, lenders should not have to require the borrower to obtain flood insurance. The Agencies are proposing questions 9 and 10 for public comment to address the issue of determining insurable value for certain nonresidential buildings that include certain low-value nonresidential buildings. Another commenter asked whether a lender would be liable if the lender allocates the overall required flood insurance over several buildings and one building suffers flood damage and is underinsured. In such a circumstance, the lender would have complied with the Act and the Regulation. Of course, the lender has the option to require the borrower to obtain more flood insurance coverage than the minimum amount required if the lender believes there is a high risk of flood loss (see final question and answer 16). Two commenters suggested that the Agencies should explain how the lender should allocate the required amount of coverage for multiple buildings of different values that secure a single loan. One of these commenters suggested that allocation could be made by a square footage method. The Agencies agree that this is one reasonable method that could be used. Other methods may include a value-based method, splitting the total coverage pro rata based on replacement cost value, or a functionality method, requiring a higher proportional share of coverage to those buildings that are most important to the ongoing operation of the borrower. The apportionment of the required coverage in any particular situation should reflect consideration by both the lender and borrower of their needs and risks. The Agencies believe no further clarification is necessary but revised the answer to address the technical issue that single-family dwellings are considered residential if less than 50 percent of the square footage is used for an incidental nonresidential purpose.

Twenty commenters addressed proposed question and answer 12, which addressed the flood insurance requirements where the insurable value of a building securing a designated loan is less than the outstanding principal balance of the loan. The comments generally raised concerns about the lack of a definition of ``insurable value,'' discussed above in connection with proposed question and answer 7. As previously mentioned, the Agencies are proposing new questions and answers 9 and 10 for public comment to address the issue of insurable value. One commenter also asked whether the Agencies will require a lender to review flood insurance policies annually at renewal and increase coverage as the replacement cost value increases. The Agencies typically will not require such a review. However, if at any time during the term of the loan, the lender determines that flood insurance coverage is insufficient, the lender must comply with the force placement procedures in the Regulation. The Agencies believe no further clarification is necessary and adopt the question and answer as proposed.

Proposed question and answer 13 (final question and answer 16) clarified that a lender can require more flood insurance than the minimum required by the Regulation. The Regulation requires a minimum amount of flood insurance; however, lenders may require more coverage, if appropriate. Two commenters asked the Agencies to specify that lenders may never require coverage that exceeds the insurable value of a building. As stated in the question and answer, lenders should avoid creating situations where a building is over-insured. Further, the Agencies state in final question and answer 8 that ``an NFIP policy will not cover an amount exceeding the insurable value of the structure.'' Another commenter asked what penalties, if any, would be imposed on a lender that requires over insurance. The Agencies note that there are no penalties for over insurance under the Act and Regulation. However, there may be penalties for over-insurance under applicable State law. Finally, a commenter suggested that flood insurance should not be required where the collateral building is worthless and would not be replaced. The Agencies are proposing questions 9 and 10 for public comment to address the issue of [[Page 35919]] determining insurable value for certain nonresidential buildings that include certain low value nonresidential buildings. Other than a nonsubstantive revision to provide additional clarity, the Agencies adopt the question and answer as proposed.

Proposed question and answer 14 (final question and answer 17) addressed lender considerations regarding the amount of the deductible on a flood insurance policy

purchased by a borrower. Generally, the proposed guidance advised a lender to determine the reasonableness of the deductible on a case-by-case basis, taking into account the risk that such a deductible would pose to the borrower and lender. The Agencies received nine comments addressing proposed question and answer 14. Four commenters suggested that borrowers with low-value buildings should be able to choose a deductible that exceeds the value of the building with a result that flood insurance would not be required. The Act and Regulation require flood insurance on all buildings at the lesser of the outstanding principal balance of the loan or the maximum amount available under the Act. A high deductible does not provide a de facto waiver of this requirement. One commenter suggested that the
Agencies' position regarding not allowing a de facto waiver of the flood insurance requirement on low-value buildings based on the deductible amount contradicts the NFIP's policy of following the
standard practice in the financial industry of allowing lenders to dictate the amount of the deductible according to the authority found in the loan agreement. Other commenters stated that a lender should not be required to determine deductibles on a case-by-case basis but rather through adoption of credit guidelines that apply across-the-board to all loans. In general, the Agencies agree that lenders may adopt credit guidelines that apply to most loans. However, such guidelines cannot work to waive the flood insurance requirements of the Act and Regulation. Finally, one commenter suggested that the Agencies should mention that the GSEs may have maximum allowable deductibles. The Agencies decline to revise the question and answer based on this comment because information about GSE requirements is outside the scope of this guidance. The Agencies adopt the question and answer as proposed.

Section III. Exemptions From the Mandatory Flood Insurance Requirements

This section contains only one question and answer, which describes the statutory exemptions from the mandatory flood insurance requirements. Proposed question and answer 15 (final question and
answer 18) was revised from the 1997 Interagency Questions and Answers to provide greater clarity, with no intended change in substance or meaning. The Agencies did not receive any substantive comments and adopt the question and answer as proposed.

Section IV. Flood Insurance Requirements for Construction Loans

The Agencies proposed this new section to clarify the requirements regarding the mandatory purchase of flood insurance for construction loans to erect buildings that will be located in an SFHA in light of concerns raised by some regulated lenders regarding borrowers' difficulties in obtaining flood insurance for construction loans at the time of loan origination. The Agencies received a number of comments on the proposed questions and answers concerning construction loans. Several commenters asked for guidance in determining the appropriate amount of flood insurance for a loan secured by a building during the course of construction. This guidance is provided in the discussion of the proposed new questions and answers 9 and 10 for public comment that addresses insurable value.

Proposed question and answer 16 (final question and answer 19) revises existing guidance to limit its scope and explained that a loan secured only by land located in an SFHA is not a designated loan that would require flood insurance coverage. The Agencies received one comment addressing this question and answer from a financial institution commenter that asked whether a loan secured by developed land without a structure on it, which, during the course of the loan, will not have any structure on it, necessitates a flood determination as it is considered residential real estate. The Agencies believe that the commenter has raised a valid point and have revised the proposed question and answer by removing the reference to ``raw'' land. The revised question and answer discusses loans secured only by ``land.'' Since a designated loan is a loan secured by a building or mobile home that is located or to be located in an SFHA, any loan secured only by land that is located in an SFHA is not a designated loan since it is not secured by a building or mobile home. In the case of this particular comment, the loan is not secured by either a building or mobile home; therefore, it is not a designated loan. The Agencies adopt the question and answer as proposed with the modification described above.

Proposed question and answer 17 (final question and answer 20) addressed whether a loan secured or to be secured by a building in the course of construction that is located or to be located in an SFHA in which flood insurance is available under the Act is a designated loan. The proposed answer provided that a lender must make a flood determination prior to loan origination for a construction loan. If the flood determination shows that the building securing the loan will be located in an SFHA, the lender must provide notice to the borrower, and must comply with the mandatory purchase requirements.

One financial institution commenter asked whether the lender/servicer must provide continuing flood insurance coverage where a structure in an SFHA covered by flood insurance is considered a total loss/demolished and only the land remains and the structure is to be rebuilt. The Agencies believe that if there is remaining insurable value in the building, flood insurance should continue to be maintained. If the building has no remaining insurable value, then flood insurance is not required. Under these circumstances, the total loss situation is akin to a loan secured only by land located in an SFHA, which is addressed in final question and answer 19 discussed above, and is not a designated loan that would require flood insurance coverage. If the building is a total loss/demolished and has no remaining insurable value, but a new structure is going to be built in its place, it should be treated like a new construction loan as discussed below in proposed question and answer 19 (final question and answer 22). To the extent that any new structure that will be built is, or will be, located in an SFHA, then the lender must provide notice to the borrower, and must comply with the mandatory purchase requirements as outlined in proposed questions and answers 18 and 19 (final questions and answers 21 and 22). The lender can, of course, elect to maintain the flood insurance that had previously been in place on the prior demolished structure to avoid having to monitor the reconstruction as discussed below.

Another financial institution commenter asked whether a building in the course of construction that will be a condominium building when finished can be insured under a Residential Building Condominium Association Policy (RCBAP) during the construction period. The RCBAP can be sold to a condominium association only. Therefore, unless the building is under [[Page 35920]] the condominium form of ownership with a condominium association formed at the time of construction, no RCBAP can be written. If there is no condominium association, the lender should require the builder/developer to obtain flood insurance under the NFIP General Property form or private equivalent. If the building will be a residential condominium, then the lender must require flood insurance to meet the statutory requirements, up to the $250,000 flood insurance limit under the NFIP for an ``other residential'' building.

Finally, a loan servicer commenter asked the Agencies to clarify when flood insurance coverage takes effect when a lender opts to require flood insurance at origination of a construction loan. This comment is addressed in final question and answer 21. The Agencies adopt the final question and answer 20 as proposed.

Proposed question and answer 18 (final question and answer 21) explained that, generally, a building in the course of construction is eligible for coverage under an NFIP policy, and that coverage may be purchased prior to the start of construction. One financial institution commenter asked whether the definition of a ``building'' in the proposed question and answer has the same meaning as FEMA's definition in its Mandatory Purchase of Flood Insurance Guidelines.\2\ The Agencies believe that the definitions of ``building,'' as well as the definition of ``building in the course of construction,'' used by FEMA are fully consistent with the definition in the Regulation. The Agencies adopt the question and answer as proposed with only minor clarifications to the citation of FEMA's Flood Insurance Manual.

\2\ FEMA, Mandatory Purchase of Flood Insurance Guidelines (September 2007) at GLS--1-2. FEMA has made this booklet available electronically at tp://www.fema.gov/library/viewRecord.do?id=2954. Hard copies are available by calling FEMA's Publication Warehouse at (800) 480-2520.

Proposed question and answer 19 (final question and answer 22), addressed when flood insurance must be purchased for buildings under the course of construction. The answer provided lenders with flexibility regarding the timing of the mandatory purchase requirement for construction loans in response to concerns raised by lenders that borrowers have encountered difficulties in obtaining flood insurance for construction loans at the time of origination. Specifically, the Agencies proposed to permit lenders to allow borrowers to defer the purchase of flood insurance until a foundation slab has been poured and/or an elevation certificate has been issued. Lenders choosing this option, however, must require the borrower to have flood insurance in place before funds are disbursed to pay for building construction on the property securing the loan (except as necessary to pour the slab or perform preliminary site work). A lender who elects this approach and does not require flood insurance at loan origination must have adequate internal controls in place to ensure compliance. Moreover, lenders must still ensure that the required flood determination is completed at origination and that notice is given to borrowers if the property is located in an SFHA.

A financial institution and a financial institution membership organization commented that requiring lenders to have monitoring procedures in place to ensure that the borrower obtains flood insurance as soon as the foundation is complete or the elevation certificate issued is too burdensome. The Agencies note that if a lender determines that this option is too burdensome they may continue the practice of requiring flood insurance at origination. The monitoring procedures are only necessary in the event that lenders choose to require flood insurance at the time the foundation pad is completed and/or the elevation certificate is obtained. Therefore, the Agencies believe that no revision to the proposed question and answer is necessary.

Several commenters, including four financial institutions and a law firm that advises financial institutions, asked the Agencies for clarification regarding the ``timing'' options available for
determining whether flood insurance is required for buildings in the course of construction, that is, the foundation alone and/or the issuance of an elevation certificate. Either the pouring of the
foundation slab or the issuance of an elevation certificate provides sufficient information for a lender to determine whether the collateral building is located in an SFHA for which flood insurance is required. The Agencies believe that no further elaboration is necessary to address this issue in the question and answer.

Finally, one individual commenter indicated that it is unclear whether an NFIP policy can be purchased before two walls and a roof have been erected. FEMA guidance provides that buildings yet to be walled and roofed are generally eligible for coverage after an elevation certificate is obtained or a foundation slab is poured, except where either construction is halted for more than 90 days or if
the lowest floor used for rating purposes is below Base Flood Elevation (BFE). If the lowest floor is under BFE, then the building must be walled and roofed before flood insurance coverage is available.\3\ The Agencies believe that the commenter has raised a valid point and have clarified the proposed question and answer accordingly. The Agencies otherwise adopt the question and answer as proposed.

\3\ FEMA, Mandatory Purchase of Flood Insurance Guidelines, at 30-31.

The Agencies also proposed new question and answer 20 (final question and answer 23) to clarify whether the 30-day waiting period for an NFIP policy applies when the purchase of flood insurance is deferred in connection with a construction loan since there has been confusion among lenders on this issue in the past. Per guidance from FEMA, the answer provided that the 30-day waiting period would not apply in such cases.\4\ The NFIP would rely on the insurance agent's representation that the exception applies unless a loss has occurred during the first 30 days of the policy period. The Agencies did not receive any substantive comments and adopt the question and answer as proposed.

\4\ FEMA, Mandatory Purchase of Flood Insurance Guidelines, at 30.

Section V. Flood Insurance Requirements for Nonresidential Buildings

The Agencies proposed this new section to address the flood insurance requirements for agricultural buildings that are taken as security for a loan, but that have limited utility

to a farming
operation, and loans secured by multiple buildings where some are located in an SFHA and others are not. Six commenters suggested that this section should be broadened to include all nonresidential
buildings, including multiple nonresidential buildings over a large geographic area, not just those related to agriculture. The Agencies concur and have changed the title to section V to read ``Flood
Insurance Requirements for Nonresidential Buildings'' and modified proposed questions and answers 21 and 22 (final question and answers 24 and 25) accordingly. Several commenters asked for guidance in determining the appropriate amount of flood insurance for loans secured by a nonresidential building, particularly for nonresidential buildings of low to no value. The Agencies are proposing questions 9 and 10 for public comment to address the issue of determining insurable value for certain nonresidential buildings that include certain low value nonresidential buildings.

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Proposed question and answer 21 (final question and answer 24) explained that all buildings taken as security for a loan and located in an SFHA require flood insurance. The question and answer also explained that lenders may consider ``carving out'' a building from the security for a loan; however, it may be inappropriate for credit risk management reasons to do so. One commenter questioned whether lenders need to require flood insurance when the collateral is only a building (in the commenter's case, a grain bin) and not the real property where the building is located. Further, the commenter stated that they only use a UCC fixture filing to secure the building. Flood insurance is required for any building taken as collateral when that building is located in an SFHA in a participating community. This requirement is not predicated on whether the underlying real estate is also included in the loan collateral or the method used by the lender to secure its collateral. FEMA answered the question of whether a grain bin is a building by specifically including a grain bin in its definition of a nonresidential building, therefore flood insurance is required.\5\

\5\ FEMA, Flood Insurance Manual, GR 2.

A commenter stated that if the value of a building is worthless or nearly zero then flood insurance should not be required. The Act requires all buildings located in an SFHA and in a participating
community to have flood insurance with only two exemptions--when a building is State-owned and covered by self-insurance satisfactory to the Director of FEMA; and when the original loan balance is $5,000 or less and the original repayment term is one year or less. All other buildings are required to be covered by flood insurance. The Agencies are proposing questions 9 and 10 for public comment to address the issue of determining insurable value for certain nonresidential buildings that include certain low value nonresidential buildings.

Another commenter suggested that in determining ``insurable value,'' institutions should be permitted to place good faith reliance on insurance agents who are better equipped to make these determinations. Federally regulated lenders may solicit assistance when evaluating insurable value and this assistance could include an insurance professional. However, it is ultimately the lender's responsibility to determine the insurable value of a building and, as such, it must concur with the determination. The same commenter also asked the Agencies to explain the rationale for treating hazard insurance and flood insurance differently. The reason for treating flood insurance and hazard insurance differently is that flood insurance includes coverage for the repair or replacement cost of the foundation and supporting structures whereas hazard insurance typically does not include coverage of the foundation. Therefore, the calculation of insurable value for flood insurance includes these repair or replacement costs while the calculation of insurable value for hazard insurance does not.

Lastly, a commenter suggested that the Agencies include additional questions and answers about other problems that arise between lenders and insurance companies, such as insurance companies requiring higher amounts of coverage than the appraised value of a structure of minimal value. The amount of flood insurance required by the Act is the lesser of the outstanding principal balance of the loan, the maximum allowed under the Act, or the insurable value. The appraised market value of the structure is not a factor in determining the amount of required insurance. The Agencies adopt question and answer 21 with the changes made to include all nonresidential buildings and not just agricultural buildings.

Proposed question and answer 22 (final question and answer 25) addressed the flood insurance requirements for multiple agricultural buildings located throughout a large geographic area, some in an SFHA and some not. One commenter suggested that the Agencies modify the first sentence in the proposed answer to refer to ``improved property'' rather than ``property.'' The Agencies concur with this recommendation and have inserted ``improved real estate'' in the place of the term ``property'' throughout the answer. The term ``improved real estate,'' instead of the suggested ``improved property,'' was added because it is the term used in the Act.

A commenter asked the Agencies to address the situation where an insurance company requires flood insurance on all buildings on the property, not just those inside an SFHA and another commenter asked the Agencies to mention that a lender can require flood insurance on buildings not located in an SFHA. The Act does not prohibit a lender from requiring more flood insurance than the minimum required by the Act; a lender may have legitimate business reasons for requiring more flood insurance than that required by the Act and neither the Act nor the Regulation prohibits this additional flood insurance. Finally, a commenter suggested that the Agencies modify the second to last sentence in the answer to refer to ``improved property securing the loan'' rather than ``designated loan.'' The Agencies have deleted this sentence entirely as it is not needed to answer the question. The Agencies adopt the question and answer with the modifications discussed above.

Section VI. Flood Insurance Requirements for Residential Condominiums

The Agencies proposed this new section to address flood insurance requirements for residential condominiums. The proposed section contained two previously existing questions and answers, which were modified and expanded, and five new questions and answers. The Agencies received numerous comments addressing this section.

A number of commenters addressed the 2007 FEMA requirement that insurance companies providing a Residential Building Association Policy (RCBAP) include the replacement cost value of the condominium building and the number of units in the building on the declaration page.\6\ Two commenters suggested that the Agencies should enforce this requirement over all insurance companies. The Agencies strongly support this FEMA requirement; however, the Agencies may only enforce the requirement against those entities over which the Agencies have jurisdiction.

\6\ FEMA Memorandum for Write Your Own (WYO) Principal Coordinators and NFIP Servicing Agent (Apr. 18, 2004) (subject: Oct. 1, 2007 Program changes).

Proposed question and answer 23 (final question and answer 26) explained that residential condominiums were subject to the statutory and regulatory requirements for flood insurance. The Agencies received only one comment addressing this question and answer, which was in agreement with the guidance. The Agencies adopt the question and answer as proposed.

One commenter suggested that an RCBAP should be described in a separate question and answer in this section. Although the RCBAP was described within the proposed questions and answers, the Agencies have compiled the information from proposed questions and answers 24 and 25 into new question and answer 27 to specifically describe an RCBAP, and renumbered the remaining questions and answers accordingly.

Proposed question and answer 24 (final question and answer 28) [[Page 35922]] discussed the amount of flood insurance that a lender must require with respect to residential condominium units to comply with the mandatory purchase requirements under the Act and the Regulation. The Agencies received a number of comments addressing various aspects of this question and answer.

Several commenters suggested that lenders should be able to rely on the replacement cost value and number of units provided on the declaration page of the RCBAP in determining the insurable value of a condominium unit. The Agencies generally agree that a lender may rely on the replacement cost value and number of units provided on the declaration page unless it has reason to believe that such amounts conflict with other available information. If there is a conflict, the lender should notify the borrower of the facts that cause the lender to believe there is a conflict. If the lender believes that the borrower is underinsured, it should require the purchase of a Dwelling Policy for supplemental coverage. The Agencies have modified the question and answer accordingly.

Several commenters asked about other types of valuation information that may be appropriate to use in determining the insurable value of a condominium unit when the insurance provider does not include the replacement cost value and number of units on the RCBAP's declaration page. While the Agencies believe that the question and answer does not require further elaboration on this point, the Agencies note that consistent with safe

and sound lending practices, lenders should maintain information about the value of their collateral. Even if the insurance provider does not include the replacement cost value of the condominium building and the total number of units on the declaration page, lenders typically have other sources of valuation information, including cost-approach appraisals, automated valuation systems, and tax assessments. Further, many lenders' policies and procedures include obtaining specific documentation related to condominium collateral that
may provide information about the condominium's insurable value, including copies of condominium master insurance policies or the declaration pages of such policies. The Agencies generally will not
criticize a lender that, in good faith, has used a reasonable method to determine the insurable value.

Several commenters agreed that RCBAP coverage written at replacement cost value, assuming that value is less than the outstanding principal amount of the loan or the maximum available under
the Act, is the appropriate insurable value for a condominium building and that an RCBAP with that coverage would meet the mandatory purchase requirement for an individual unit borrower. The 1997 Interagency Questions and Answers stated that RCBAP coverage of 80 percent of replacement cost value was sufficient to meet the mandatory purchase requirement. Because of this change in policy, commenters urged the Agencies to ensure that the new guidance will apply only prospectively. Consistent with the stated intention in the March 2008 Proposed Interagency Questions and Answers, the Agencies intend that this guidance will apply to any loan that is made, increased, extended, or renewed on or after the effective date of these Interagency Questions and Answers.

The Agencies had previously indicated in the SUPPLEMENTARY INFORMATION to the March 2008 Proposed Interagency Questions and Answers that the new guidance would apply to a loan made prior to the effective date of this guidance, but only as of the first flood insurance policy renewal following the effective date of the guidance. Three commenters asked the Agencies to reconsider this position. The commenters asserted that lenders making loans secured by individual condominium units generally do not receive RCBAP renewal notifications from the insurance providers; therefore, the lender may not be in a position to make a determination at the first RCBAP renewal period following the effective date of this guidance.

Lenders are required to ensure that designated loans are covered by flood insurance for their term. However, the Agencies recognize that lenders made loans and required coverage amounts in reliance on the previous guidance. Therefore, the Agencies have agreed that the revised guidance will not apply to any loan made prior to the effective date of this guidance unless a trigger event occurs in connection with the loan (that is, the loan is refinanced, extended, increased, or renewed). Because the Agencies provided supervisory guidance that stated that an RCBAP with coverage at 80 percent of replacement cost value was sufficient, any loan for a condominium unit relying on an RCBAP with coverage that complied with that guidance was in compliance at the time it was made. Absent a new trigger event, the Agencies, therefore, will not require lenders to ensure that RCBAP coverage is increased to 100 percent on previously compliant loans made prior to the effective date
of this new guidance. The Agencies have revised the proposed question and answer

accordingly. The Agencies anticipate that the universe of loans affected by this policy will be relatively small and diminishing due to refinancing and other loan prepayments that typically occur in the first five years of a home mortgage.

Proposed question and answer 25 (final question and answer 29) addressed what a lender that makes a loan on an individual condominium unit must do if there is no RCBAP coverage. Three commenters addressed this question and answer. One commenter suggested that, in the example, the Agencies should clarify that the amount of insurance required is the ``minimum amount'' because that value ($175,000) is based on the principal amount of the loan, which is less than either the insurable value of the unit ($200,000) or the maximum amount available in a dwelling policy ($250,000). In response to this comment, the Agencies have added the qualifier ``at least'' before the amount of $175,000 to clarify that $175,000 is the minimum amount of insurance that must be required. As in other situations, a lender may require additional coverage.

Another commenter asked whether a unit owner's dwelling policy will respond at all if there is no RCBAP on the condominium building. Although this is a general insurance question that is outside the Agencies' purview, FEMA guidance provides that, when there is no RCBAP coverage on the condominium building, the unit owner's dwelling policy will respond to losses to improvements owned by the insured and to assessments charged by the condominium association, up to the building coverage limits of the dwelling policy purchased.\7\ Finally, one other commenter suggested that, when a condominium association refuses to purchase an RCBAP, the lender should refuse to make a loan to a unit owner because the unit owner's dwelling policy is not adequate to protect the lender. The Agencies agree that there is risk to the lender in accepting a dwelling policy as protection for the collateral. However, this is a risk that the lender must weigh. Such policy, however, does fulfill the mandatory purchase requirement. The Agencies have amended the proposed question and answer to include additional discussion on dwelling policies in response to these comments. The
[[Page 35923]] Agencies otherwise adopt the question and answer as proposed.

\7\ See FEMA, Mandatory Purchase of Flood Insurance Guidelines at 48-49; FEMA Flood Insurance Manual at p. POL 8 (FEMA's Flood Insurance Manual is updated every six months).

Proposed question and answer 26 (final question and answer 30) discussed what a lender must do if the condominium association's RCBAP coverage is insufficient to meet the mandatory purchase requirements for a loan secured by an individual residential condominium unit. Several commenters suggested changes to FEMA's flood insurance policies. It is beyond the Agencies' jurisdiction to address these suggestions, which are within the purview of FEMA. Interested parties should appropriately consult with FEMA concerning the actual operation of flood insurance policies.

Several other commenters noted that the purchase of a unit owner's dwelling policy may not provide adequate coverage to the unit owner or the lender as a supplement to an RCBAP providing insufficient coverage to meet the mandatory purchase requirement. As noted in the proposed question and answer, a dwelling policy may contain claim limitations; therefore, it is incumbent upon a lender to understand these limitations.

Several commenters also suggested that the Agencies should not put forth guidance encouraging lenders to apprise borrowers that there is risk involved when flood coverage is maintained under a unit owner dwelling policy along with an RCBAP that does not provide replacement cost coverage. The Agencies believe that although insurance professionals are in the best position to adequately explain the implications of such coverage, lenders should still be encouraged to alert their borrowers to the risk. FEMA's brochure, National Flood Insurance Program: Condominium Coverage, may provide some helpful information for borrowers. The Agencies adopt the question and answer as proposed.

Proposed question and answer 27 (final question and answer 31) discussed what a lender must do when it determines that a loan secured by a residential condominium unit is in a complex with a lapsed RCBAP. One commenter requested that the Agencies provide more guidance on the steps a lender should take to determine if there is a lapse in existing RCBAP coverage. As mentioned above, the Agencies are aware that, generally, a lender that is the mortgagee of a unit owner's loan would not receive notice that the condominium association's RCBAP has expired. However, if a trigger event occurs (that is, the lender makes, increases, extends, or renews a loan to the borrower secured by the unit) or if the lender otherwise makes a determination that the RCBAP has expired, then the lender will be required to follow the procedure outlined in final question and answer 28 and discussed above. The Agencies adopt the question and answer as proposed.

Proposed question and answer 28 (final question and answer 32) provided examples of how the co-insurance penalty applies when an RCBAP is purchased at less than 80 percent of replacement cost value, unless the amount of coverage meets the maximum coverage of $250,000 per unit. Two commenters asked about the purpose of this question and answer. The Agencies intended this question and answer to provide information on the topic to lenders. The Agencies adopt the question and answer as proposed.

Proposed question and answer 29 (final question and answer 33) addressed the major factors that are involved with coverage limitations of the individual unit owner's dwelling policy with respect to the condominium association's RCBAP coverage. One commenter asked the purpose of this question and answer and further asserted that lenders should not be required to explain to borrowers about the limitations in coverage. The Agencies intended this question and answer to be informative in nature and agree that insurance professionals are in a better position to explain policy limitations to their policyholders. The Agencies adopt the question and answer as proposed.

Section VII. Flood Insurance Requirements for Home Equity Loans, Lines of Credit, Subordinate Liens, and Other Security Interests in Collateral Located in an SFHA

Proposed Section VII addressed flood insurance requirements for home equity loans, lines of credit, subordinate liens, and other security interests in collateral located in an SFHA. The proposed questions and answers primarily proposed only minor wording changes or clarifications to questions and answers in the 1997 Interagency Questions and Answers without any change in the substance or meaning. Several commenters addressed questions and answers in this section.

Proposed question and answer 30 (final question and answer 34), addressed when a home equity loan is considered a designated loan that requires flood insurance. The Agencies did not receive any substantive comments and adopt the question and answer as proposed.

Proposed question and answer 31 (final question and answer 35), addressed when a draw against an approved line of credit secured by property located in an SFHA requires flood insurance. Nine commenters questioned the statement that a designated loan requires a flood determination when application is made for that loan. The commenters noted that under the Act and Regulation, a lender or its servicer is responsible for performing a flood determination upon the making, increase, extension, or renewal of a loan, and not when a loan application is submitted. They further noted that applications are often withdrawn and that lenders usually have a flood determination performed when they are reasonably certain that one of the previously listed ``trigger'' events (e.g., the making or increasing) will occur. The commenters requested that this point be clarified. The Agencies agree with the commenters and are deleting the statement that a designated loan requires a flood determination when application is made for that loan. The Agencies otherwise adopt the question and answer as proposed.

Proposed question and answer 32 (final question and answer 36) addressed how much flood insurance is required when a lender makes a second mortgage secured by property located in an SFHA. Six commenters argued that a junior lienholder should not have to take senior liens into account when determining the required amount of flood insurance coverage. They asserted that the current requirement causes substantial cost and delay, resulting in an undue burden due to the need for either the junior lienholder or its servicer to engage in an expensive, time-consuming search for prior liens. One commenter contended that the question and answer should state that the amount of coverage for a junior lien would be 100 percent of the insurable value of the property. Alternatively, the same commenter suggested multiple flood insurance policies on buildings with multiple liens as a means to address the problem. On the other hand, one commenter believed that the question and answer should remind lenders to add secondary loans to any existing flood insurance policy's mortgagee clause. Three commenters requested more guidance on how and when a lienholder should determine the value of any other liens on improved collateral property. One of these mentioned closing or upon renewal of a loan as two possible dates for such activity.

The Agencies believe that, given the provisions of an NFIP policy, a lender cannot comply with Federal flood insurance requirements when it makes, [[Page 35924]] increases, extends, or renews a loan by requiring the borrower to obtain NFIP flood insurance solely in the amount of the outstanding principal balance of the lender's junior lien without regard to the flood insurance coverage on any liens senior to that of the lender. As illustrated in the examples in the question and answer, a junior lienholder's failure to take such a step can leave that lienholder partially or even fully unprotected by the borrower's NFIP policy in the event of a flood loss.

The final question and answer provides that a junior lienholder should work with the borrower, senior lienholder, or both these parties, to determine how much flood insurance is needed to adequately cover the improved real estate collateral to the lesser of the total of the outstanding principal balances on the junior loan and any senior loans, the maximum available under the Act, or the insurable value of the structure. The junior lienholder should also ensure that the borrower adds the junior lienholder's name as mortgagee/loss payee to an existing flood insurance policy.

The final question and answer also provides that a junior lienholder should obtain the borrower's consent in the loan agreement or otherwise for the junior lienholder to obtain information on balance and existing flood insurance coverage on senior lien loans from the senior lienholder. Commenters also contended that privacy concerns make it difficult for junior lienholders to obtain information from servicers or lenders about loan balances and existing flood insurance coverage. However, the Agencies have determined that the privacy provisions of the Gramm-Leach-Bliley Act, as implemented in the Agencies' regulations, do not prohibit sharing of the loan and flood insurance information between two lenders with liens on the same property, even without the borrower's consent.

One commenter noted that it is sometimes difficult to obtain information about the outstanding principal balance of other liens once a loan has been closed, such as at loan renewal, and asked what steps might be taken in that regard. The final question and answer states that junior lienholders have the option of obtaining a borrower's credit report to establish the outstanding balances of senior liens on property to aid in determining how much flood insurance is necessary upon increasing, extending or renewing a junior lien.

In the limited situation where a junior lienholder or its servicer is unable to obtain the necessary information about the amount of flood insurance in place on the outstanding balance of a senior lien (for example, in the context of a loan renewal), the final question and answer provides that the junior lienholder may presume that the amount of insurance coverage relating to the senior lien in place at the time the junior lien was first established (provided that the amount of flood insurance coverage relating to the senior lien was adequate at the time) continues to be sufficient.

The Agencies have revised the proposed question and answer to respond to these comments. The question and answer also provides examples illustrating the application of these methods of dealing with adequate flood insurance coverage for junior and senior liens. Specifically, the examples illustrate how a junior lienholder should handle situations such as: when a senior lienholder has obtained an inadequate amount of flood insurance coverage, when a senior lienholder is not subject to the Act's and Regulation's requirements; and when insurance coverage in the amount of the improved real estate's insurable value must be obtained by the junior lienholder.

Commenters also raised other issues related to ongoing flood insurance coverage on existing second lien loans in the context of force placement. The final question and answer addresses the triggering events of making, increasing, extending, and renewing a second lien loan.

Proposed question and answer 33 (final question and answer 37) addressed flood insurance requirements in connection with home equity loans secured by junior liens. Ten commenters requested that the question and answer be clarified to address other subordinate lien loans, not just junior lien home equity loans. The Agencies agree with the commenters and, therefore, have revised the question and answer to clarify that it applies to all subordinate lien loans.

Another commenter recommended that the ``same lender'' exception also apply to a lender's affiliates. The Act provides that a person who increases, extends, renews, or purchases a loan secured by improved real estate or a mobile home may rely on a previous determination of whether the building or mobile home is located in an area having special flood hazards, if the previous determination was made no more than seven years before the date of the transaction and there have been no subsequent map revisions. 42 U.S.C. 4104b(e). The Act further defines the term ``person'' to include any individual or group of individuals, corporation, partnership, association, or any other organized group of persons, including State and local governments and agencies thereof. 42 U.S.C. 4121(a)(5). The Agencies do not interpret the definition as providing for the inclusion of affiliates within a corporate entity as constituting a single ``person'' except for treating a regulated lending institution and its operating subsidiaries as a single entity. The Agencies believe that no further revision of the question and answer is appropriate on this point. The Agencies adopt the question and answer as proposed subject to the revisions discussed above.

Proposed question and answer 34 (final question and answer 38) addressed the issue of whether a loan secured by inventory stored in a building located in an SFHA, when the building is not collateral for the loan, requires flood insurance. One commenter asked what sort of legal instrument would have to be filed by a lender to result in the need for flood insurance coverage for a borrower's contents. The Agencies decline to respond to this inquiry because it involves a business and legal decision beyond the interpretation of the Act and Regulation. The Agencies adopt the question and answer as proposed.

Proposed question and answer 35 (final question and answer 39) addressed flood insurance requirements when building contents are security for a loan. Seven commenters requested further guidance and clarification on how to calculate flood insurance contents coverage in compliance with Federal regulation. Five commenters specifically requested that the Agencies give examples to illustrate how flood insurance coverage works for building and contents. Two commenters asked whether a lender should consider the total amount of coverage for both contents and building together or should consider the two separately. One commenter asked whether a lender could do the same with contents and building coverage as is the practice with coverage for multiple buildings, that is, the contents and building will be considered to have a sufficient amount of flood insurance coverage for regulatory purposes as long as some amount of insurance is allocated to
each category.

The Agencies agree that the practice for flood insurance coverage for multiple buildings would also be applicable to coverage for both contents and building. That is, both contents and building will be considered to have a sufficient amount of flood insurance coverage for regulatory purposes as long as some reasonable amount of insurance [[Page 35925]] is allocated to each category. The Agencies have added an example to this question and answer to illustrate this point. The Agencies otherwise adopt the question and answer as proposed.

Proposed question and answer 36 (final question and answer 40), addressed the flood insurance requirements applicable to collateral or contents that do not secure a loan. The Agencies did not receive any substantive comments and adopt it as proposed.

Proposed question and answer 37 (final question and answer 41) addressed the Regulation's application where a lender places a lien on property out of an ``abundance of caution.'' One commenter recommended that flood insurance coverage should not be required when an interest is taken by a lender in improved real estate in a flood hazard zone out of an ``abundance of caution.''

The Agencies decline to accept this recommendation. The Act provides that a lender may not make, increase, extend, or renew any loan secured by improved real estate or a mobile home in a flood hazard area unless the building or mobile home is covered for the term of the loan by flood insurance. 40 U.S.C. 4012a(b)(1). The statute makes no exception for property taken as collateral by a lender out of an abundance of caution. The Agencies adopt the question and answer as proposed.

Proposed question and answer 38 (final question and answer 42) addressed loans secured by a note on a single-family dwelling, but not the dwelling itself. Proposed question and answer 39 (final question and answer 43) pertained to loans personally guaranteed by a third party who gave the lender a security interest in improved real estate owned by the guarantor. One commenter stated that the two proposed questions and answers conflicted. The Agencies do not believe there is a conflict between the two questions and answers. In the former question and answer, the Agencies concluded that Federal flood insurance requirements did not apply because the loan was not secured by improved real estate, but was instead secured by a note. In the latter question and answer, the lender was given a security interest in improved real estate by a third party in connection with the third party providing a personal guarantee on a loan. In each situation, the absence or presence of a security interest in improved real estate determined whether Federal flood insurance requirements would apply. The Agencies believe that no further elaboration is necessary and adopt these questions and answers as proposed.

Section VIII. Flood Insurance Requirements in the Event of the Sale or Transfer of a Designated Loan and/or Its Servicing Rights

Proposed Section IX (final Section VIII) addressed flood insurance requirements in the event of the sale or transfer of a designated loan and/or its servicing rights. This section and the accompanying questions and answers were originally adopted in the 1997 Interagency Questions and Answers, and any changes proposed by the Agencies in the March 2008 Proposal were designed to provide greater clarity with no intended change in substance and meaning. The comments received by the Agencies regarding the questions and answers in this section were generally supportive.

Proposed question and answer 41 (final question and answer 44) addressed the application of the flood insurance requirements under the Regulation to lenders/loan servicers under different scenarios. Upon consideration of the various comments, the Agencies have clarified the question and answer to apply to both regulated and nonregulated lenders. One commenter was supportive of the guidance, but recommended that lenders be allowed to assign a certain level of responsibility for flood insurance compliance through contractual arrangements to the servicer. The commenter asserted that this approach would not absolve lenders of liability and ultimate responsibility, but would make for a less burdensome and logical approach. The Agencies believe that the lender's responsibilities are sufficiently clear in the question and answer and that further elaboration on this point is unnecessary.

Another commenter asked that the Agencies expressly indicate that no servicing obligations need be followed by a lender who has sold both the loan and the servicing rights to a nonregulated party. The Agencies have elected to clarify in the answer that once the regulated lender has sold the loan and the servicing rights, the lender has no further obligation regarding flood insurance on the loan. The Agencies have also elected to clarify in the answer that, depending upon the circumstances, safety and soundness considerations may sometimes necessitate that the lender undertake sufficient due diligence upon purchase of a loan as to put the lender on notice of lack of adequate flood insurance. Moreover, if the purchasing lender subsequently extends, increases, or renews a designated loan, it must also comply with the Act and Regulation. The Agencies otherwise adopt the question and answer as proposed.

Proposed question and answer 42 (final question and answer 45), addressed when a lender is required to notify FEMA or the Director's designee. Proposed question and answer 43 (final question and answer 46), addressed whether a RESPA Notice of Transfer sent to the Director of FEMA satisfies the Act and Regulation. The Agencies received one comment that was supportive of these proposed questions and answers. The Agencies adopt the questions and answers as proposed.

Proposed question and answer 44 (final question and answer 47), indicated that delivery of the notice can be made electronically, including by batch transmission if acceptable to the Director or the Director's designee. The Agencies did not receive any substantive comments and adopt this question and answer as proposed.

Proposed question and answer 45 (final question and answer 48) indicated that if a loan and its servicing rights are sold by the lender, the lender is required to provide notice to the FEMA Director or the Director's designee. The Agencies received one comment that was supportive of the proposed question and answer. The Agencies adopt the question and answer as proposed.

Proposed question and answer 46 (final question and answer 49), indicated that a lender is not required to provide notice when the servicer, not the lender, sells or transfers the servicing rights to another servicer; rather the servicer is obligated to provide the notice. Proposed question and answer 47 (final question and answer 50) indicated that in the event one institution is acquired by or merges with another institution, the duty to provide the notice for loans being serviced by the acquired institution falls to the successor institution if notification is not provided by the acquired institution prior to the effective date of the acquisition or merger. The Agencies received one comment that was supportive of these proposed questions and answers. The Agencies adopt the questions and answers as proposed.

Section IX. Escrow Requirements

Proposed Section X (final Section IX) addressed escrow requirements for flood insurance premiums. This section and the accompanying questions and answers were originally adopted in the 1997 Interagency Questions and Answers, and any changes proposed by the Agencies were designed to provide [[Page 35926]] greater clarity with no intended change in substance and meaning. The Agencies received few comments on this section.

Proposed question and answer 48 (final question and answer 51), addressed when multifamily buildings and mixed-use properties are considered residential real estate. A financial institution commenter requested two clarifications. First, the commenter noted that the proposed answer indicated that lenders are required to escrow flood insurance premiums and fees for any mandatory flood insurance for designated loans if the lender requires the escrow of taxes, hazard insurance premiums, ``or other loan charges'' for loans secured by residential improved real estate. The commenter questioned whether lenders are required to escrow flood insurance premiums and fees for any mandatory flood insurance for designated loans if the lender requires the escrow of mortgage insurance premiums. The Agencies believe that escrowing flood insurance premiums and fees for mandatory flood insurance for designated loans is required by the Act and
Regulation where the lender requires the escrowing of mortgage insurance premiums. The Act and Regulation require escrowing if a regulated lending institution requires the escrowing of ``taxes, insurance premiums, fees, or any other charges.'' Mortgage insurance is a form of insurance. It is also an ``other charge'' under the Regulation. To provide greater consistency with the Act and Regulation, the Agencies are inserting the word ``any'' into the answer so that it refers to taxes, insurance premiums, fees, ``or any other charges.''

The commenter also asked the Agencies to expressly state in the answer that a lender is not required to escrow flood insurance premiums if it chooses to make an exception on a loan-by-loan basis not to escrow other items such as taxes, hazard insurance premiums, or other loan charges. In response, the Agencies have added a sentence to the answer providing that a lender is not required to escrow flood insurance premiums and fees for a particular loan if it does not require escrowing of any other charges for that loan.

Finally, because the Agencies are adopting questions and answers providing examples of residential and nonresidential properties, the discussion of mixed-use properties has been revised to refer the reader to those questions and answers. If the primary use of a mixed-use property is for residential purposes, the Regulation's escrow requirements apply. The Agencies otherwise adopt the question and answer as proposed.

Proposed question and answer 49 (final question and answer 52) addressed when escrow accounts must be established for flood insurance purposes and indicated that escrow accounts should look to the definition of ``Federally related mortgage loan'' contained in the Real Estate Settlement Procedures Act (RESPA) to see whether a particular loan is subject to RESPA's escrow requirements. The Agencies did not receive any substantive comments on the proposed question and answer; however, the Agencies made nonsubstantive revisions to the answer to more directly respond to the question asked and to provide additional clarity.

The Agencies received no comments on proposed questions and answers 50 and 51 (final questions and answers 53 and 54 respectively). Proposed question and answer 50 (final question and answer 53) indicated that voluntary escrow accounts established at the request of the borrower do not trigger a requirement for the lender to escrow premiums for required flood insurance. Proposed question and answer 51 (final question and answer 54) indicated that premiums paid for credit life insurance, disability insurance, or similar insurance programs should not be viewed as escrow accounts requiring the escrowing of flood insurance premiums. The Agencies did not receive any substantive comments on these questions and answers and adopt them as proposed.

Proposed question and answer 52 (final question and answer 55) advised that only certain escrow-type accounts for commercial loans secured by multifamily residential buildings trigger the escrow requirement for flood insurance premiums. The Agencies did not receive any substantive comments and adopt this question and answer as proposed.

Proposed question and answer 53 (final question and answer 56) addressed escrow requirements for condominium units covered by RCBAPs. The Agencies received several comments on this question and answer. Two financial institution commenters reiterated their comments pertaining to proposed question and answer 24 (final question and answer 28) that lenders or servicers of a loan to a condominium unit owner do not receive a copy of the RCBAP renewal information because they are not loss payees on the policy. This comment was addressed in the SUPPLEMENTARY INFORMATION pertaining to Section VI above. A financial institution requested clarification that regardless of whether the lender makes a loan for the purchase or refinance of a condominium unit, an escrow account is not required if dues to the condominium association apply to the RCBAP premiums. The proposed question and answer only addressed purchase loans; however, the Agencies agree with the commenter that the same principle should apply to refinancings. The Agencies, therefore, are clarifying the question and answer to provide that when a lender makes, increases, renews, or extends a loan secured by condominium unit that is adequately covered by an RCBAP, and dues to the condominium association apply to the RCBAP premiums, an escrow account is not required. However, if the RCBAP coverage is inadequate and the unit is also covered by a dwelling form policy, premiums for the dwelling form policy would need to be escrowed. The Agencies otherwise adopt the question and answer as proposed.

X. Force Placement of Flood Insurance

Proposed Section XI (final Section X) addressed issues concerning the force placement of flood insurance. This section and the accompanying questions and answers were originally adopted in the 1997 Interagency Questions and Answers and any changes proposed by the Agencies in March 2008 were designed to provide greater clarity with no intended change in substance and meaning.

The Agencies received several comments on proposed question and answer 54 (final question and answer 57), which provided general guidance on the force placement requirement under the Act and Regulation. Six commenters requested further guidance regarding the exact point at which lenders must commence the force placement process. Similarly, commenters requested clarification as to precisely when the 45-day notice period begins after which a lender or its servicer must force place insurance. One of these commenters specifically asked the Agencies to clarify whether insurance is required 45 days from the date the institution received the cancellation notice, the date of cancellation on that notice, or the date that the borrower receives notice from the lender or servicer. One commenter requested clarification from the Agencies whether the 45-day notice could be sent prior to the actual date of expiration of flood insurance coverage.

As discussed in the proposed question and answer, the Act and Regulation require the lender, or its servicer, to send notice to the borrower upon making a determination that the [[Page 35927]] improved real estate collateral's insurance coverage has expired or is less than the amount required for that particular property, such as upon receipt of the notice of cancellation or expiration from the insurance provider. The notice to the borrower must also state that if the borrower does not obtain the insurance within the 45-day period, the lender will purchase the insurance on behalf of the borrower and may charge the borrower for the cost of premiums and fees to obtain the coverage. The Act does not permit a lender or its servicer to send the required 45-day notice to the borrower prior to the institution's making a determination that flood insurance is insufficient or lacking (for example, the actual expiration date of the flood insurance policy). If adequate insurance is not obtained by the borrower within the 45-day period, then the insurance must be obtained by the lender on behalf of the borrower.

Another commenter stated that if a lender decides to pay a borrower's current policy premium, this should not be considered to be purchasing a force placed policy. The Agencies agree that it is within a lender's discretion to absorb the costs of a borrower's flood insurance policy anytime during the term of the designated loan. This should not, however, eliminate the borrower's opportunity to obtain appropriate flood insurance coverage, especially during the 45-day period after receiving a force placement notice from the lender. The Agencies revised proposed question and answer 54 (final question and answer 57) to address these commenters' points.

The Agencies also received questions from commenters regarding coverage during the 45-day notice period. Two commenters asked how to ensure that collateral property is protected against flood damage during the 45-day notice period prior to actual force placement. Another commenter asked for more explanation about the coverage that continues in effect for 30 days after the date that a Standard Flood Insurance Policy (SFIP) expires under the NFIP.

Coverage under FEMA's SFIP continues in effect for 30 days from the date that the SFIP lapses. An SFIP specifically provides that, if the insurer decides to cancel or not renew a policy, it will continue in effect for the benefit of only the mortgagee for 30 days after the insurer notifies the mortgagee of the cancellation or nonrenewal. No coverage will be provided for a borrower under the SFIP during this 30-day period. If a lender monitors a mortgage loan with respect to the need for flood insurance coverage, the lender can time the 45-day period to start with the lapse of insurance coverage. Assuming notification is made immediately upon policy cancellation or nonrenewal, coverage will continue in place for the lender/mortgagee's benefit for 30 days of the 45-day notice period. To cover the risk during the remaining 15-day ``gap,'' lenders may purchase private flood insurance to cover the collateral property, as discussed further in section XI below regarding private insurance policies. Lenders in these situations, often purchase what is known in the insurance industry as a ``30-day binder,'' a form of temporary private insurance. The insurance provided by such a binder will cover the 15-day gap and the 15 days subsequent to the end of the notice period. Because these issues lie outside the scope of the Agencies' purview, however, the Agencies decline to include this guidance in the question and answer.

One commenter contended that one of the criteria for force placement in proposed question and answer 54 (final question and answer 57) should be changed from ``[t]he community in which the property is located participates in the NFIP'' to ``flood insurance under the Act is available for improved property securing the loan,'' because properties may also be in Coastal Barrier Resource Areas, Otherwise Protected Areas, or areas designated under section 1316 of the Flood Act. The Agencies have revised final question and answer 57 to reflect this requested change. Another commenter asked whether the citation to ``Appendix A of the FEMA publication'' in proposed question and answer 54 was a reference to the immediately previously cited FEMA procedures that were published in the Federal Register. The Agencies have revised final question and answer 57 to clarify the citation.

Proposed question and answer 55 (final question and answer 58), addressed whether a servicer can force place insurance on behalf of a lender. The Agencies did not receive any substantive comments and adopt the question and answer as proposed.

Proposed question and answer 56 (final question and answer 59) addressed the amount of insurance required when force placement occurs. The Agencies received one comment suggesting that the proposed answer to proposed question 56 not only cross-reference Section II of the Interagency Questions and Answers, but also refer to Section VII, because proposed question and answer 36 in that section pertains to the required amount of flood insurance for home equity loans. The Agencies have made minor clarifications based upon this comment, but otherwise
adopt the question and answer as proposed.

The Agencies received comments regarding terminology used in this section. Specifically, two commenters took exception to the use of the term ``force placement,'' arguing that the term conveys an incorrect impression that the borrower is being forced to accept the purchase of flood insurance coverage when the reverse of the situation applies. These commenters suggested that the alternative term ``lender placed'' should be used instead. The current term ``force placement'' is used in the Regulation. Moreover, the term has been widely used since the enactment of the National Flood Insurance Reform Act of 1994. Changing the term may cause confusion. For this reason, the Agencies decline to accept this suggested change.

Another commenter recommended that ``lender single interest policies'' should not be allowed and should be considered in violation of the legal requirements of the Act and Regulation since they are not purchased on the borrower's behalf and do not offer the same or better policy terms to the borrower. As discussed in further detail in the discussion to section XI below, private insurance policies may only be considered an adequate substitute for an SFIP if the policy meets the criteria set forth by FEMA, including the requirement that the coverage be as broad as an SFIP. The Agencies have declined to address this comment specifically because it is believed that the comment is addressed by the general guidance in section XI.

In response to comments received regarding the force placement of flood insurance, the Agencies are proposing three new questions and answers (60, 61, and 62), which are discussed in the SUPPLEMENTARY INFORMATION immediately following the Redesignation Table, to be added to Section VII to address the following force-placement issues: when action after learning that improved real estate that secures a loan is uninsured or underinsured, and whether a borrower may be charged for the cost of flood insurance coverage during the 45-day notice period.

XI. Private Insurance Policies

Proposed Section XII (final Section XI) addressed the appropriateness of gap or blanket insurance policies, often purchased by lenders to ensure adequate life-of-loan flood insurance coverage for designated loans. The proposed answer to question 57 (final [[Page 35928]] question and answer 63) explained, generally, that gap or blanket insurance is not an adequate substitute for NFIP insurance. The proposed answer, however, did acknowledge that in limited circumstances, a gap or blanket policy may satisfy flood insurance obligations in instances where NFIP and private insurance for the borrower are otherwise unavailable.

The Agencies received several comments regarding the proposed question and answer. Some industry commenters argued that gap or blanket insurance is a cost-effective alternative to NFIP insurance and should be permitted as a substitute for NFIP insurance in all cases. Other industry commenters argued that gap or blanket insurance should be permitted as a substitute for NFIP insurance under certain circumstances, such as for construction loans or underinsured properties. Still other industry commenters asked the Agencies to clarify the use of the terms ``gap'' and ``blanket'' policies, noting that the common industry understanding is that ``gap'' policies are distinguishable from ``blanket'' policies. In particular, these commenters requested that the Agencies eliminate the prohibition on ``gap'' policies that are meant to cover the deficiency between a borrower's coverage and the amount of insurance required under the Act and Regulation. One industry commenter also noted that there are different types of ``gap'' policies and suggested that the Agencies clarify its intentions to prohibit only certain types of ``gap'' policies. Lastly, commenters also requested general guidance on whether non-NFIP private insurance policies were permitted.

Based on these comments, the Agencies have decided to modify the question and answer to address broader issues of the appropriateness of private insurance. Instead of focusing on whether a policy is called a ``gap'' insurance policy or a ``blanket'' insurance policy, which may depend on how the policy is marketed by the insurer, the Agencies have decided that it is more appropriate to provide guidance to lenders on private insurance policies in general.

The Agencies have revised the answer to the question to provide that a private insurance policy may be an adequate substitute for an NFIP policy if it meets the criteria set forth by FEMA in its Mandatory Purchase of Flood Insurance Guidelines.\8\ As FEMA has stated in its Mandatory Purchase of Flood Insurance Guidelines, to the extent there are any differences between the private insurance policy and an NFIP Standard Flood Insurance Policy, those differences must be evaluated carefully by the lender to determine whether the policy would provide sufficient protection under the Act and Regulation. Lenders must consider the suitability of a private insurance policy only when the mandatory purchase requirements apply. Therefore, if the Act or Regulation does not require the purchase of flood insurance, the lender need not evaluate the policy to determine whether it meets the criteria set forth by FEMA.

\8\ FEMA, Mandatory Purchase of Flood Insurance Guidelines, at 57-58.

The guidance proposed in March 2008 on the limited circumstances when gap or blanket policies are permissible has been revised and is being addressed in a new separate question and answer 64. The answer to final question 64 provides that in the event that a flood insurance policy has expired and the borrower has failed to renew coverage, a private insurance policy that does not meet the criteria set forth by FEMA may nevertheless be useful in protecting the lender during a gap in coverage in the period of time before a force placed policy takes effect. However, the answer further states that the lender must force place NFIP-equivalent coverage in a timely manner and may not rely on non-equivalent coverage on an on-going basis. This is consistent with guidance proposed in March 2008, though the language has been modified in response to commenters who thought this guidance was confusing as worded in the proposal.

Section XII. Required Use of the Standard Flood Hazard Determination Form (SFHDF)

Proposed Section XIII (final Section XII) addressed the required use of the Special Flood Hazard

Determination Form (SFHDF). This section and the accompanying questions and answers were originally adopted in the 1997 Interagency Questions and Answers. The changes proposed by the Agencies in March 2008 were designed to provide greater clarity with no intended change in substance and meaning. The agencies received a number of comments on this section.

Proposed question and answer 58 (final question and answer 65), addressed whether the SFHDF replaces the borrower notification form. One commenter suggested the answer clarify the SFHDF's use to the lender and the notification form's use to benefit the borrower. The Agencies agree with the commenter and have revised the proposed answer to be more responsive to the question and to more clearly set out the respective uses of the SFHDF and the borrower notification form. Information about the notice of special flood hazards may be found in section XV. The commenter also suggested that the Agencies should amend the proposed answer to provide that the SFHDF must be used by the lender to determine if the ``improved'' property securing the loan is
located in an SFHA. The Regulation specifically provides that a lender must make a flood hazard determination and use the SFHDF when determining whether the ``building or mobile home offered as collateral security for a loan is or will be located in an SFHA in which flood insurance is available under the Act.'' The Agencies agree that it is appropriate to revise the proposed question and answer to conform to the language of the Regulation and have done so.

Proposed question and answer 59 (final question and answer 66), addressed whether a lender is required to provide a copy of the SFHDF to the applicant/borrower. The Agencies received two comments concerning the proposed question and answer. The commenters suggested that the answer should state that the Act does not require that the lender provide the borrower with a copy of the SFHDF. The Agencies have revised the proposed question and answer to note that, while not a statutory requirement, a lender may provide a copy of the flood determination to the borrower so the borrower can provide it to the insurance agent in order to minimize flood zone discrepancies between the lender's determination and the borrower's policy. A lender would also need to make the determination available to the borrower in case of a special flood hazard determination review, which must be requested jointly by the lender and the borrower. In the event a lender provides
the SFHDF to the borrower, the signature of the borrower is not required to acknowledge receipt of the form.

Proposed question and answer 60 (final question and answer 67) addressed the use of the SFHDF in electronic format. The Agencies did not receive any substantive comment and adopt the question and answer as proposed.

Proposed question and answer 61 (final question and answer 68) addressed the circumstances when a lender may rely on a previous special flood hazard determination. The Agencies received several comments concerning this question and answer. One commenter suggested that, if a lender maintains life-of-loan tracking, there is little benefit in obtaining a new special flood hazard determination [[Page 35929]] when renewing, refinancing, or extending a loan if the original determination is older than seven years. The authority to rely on a previous determination made within the previous seven years if that determination meets certain requirements is statutory (42 U.S.C. 4104b(e)). Accordingly, seven years is the maximum period during which a lender may rely on a previous determination, even if the lender has maintained life-of-loan tracking.

Two commenters suggested that the proposed question and answer should also address whether a lender may rely on one determination if a lender makes multiple loans to one borrower, all of which are secured by the same improved property. For example, it should address when a lender may rely on a single determination when making a home purchase loan and a subsequent home equity loan, both secured by the same residence. The situation described by the commenters is similar to the example of a refinancing or assumption by a lender, which obtained the original flood determination on the same security property. In that case, the question and answer states that the lender may rely on the original determination if the original determination was made not more than seven years before the date of the transaction, the basis of the determination was set forth on the SFHDF, and there were no map revisions or updates affecting the security property since the original determination was made. The Agencies based this interpretation on the premise that a refinancing would be the functional equivalent of either a loan extension or renewal. Subsequent loans to the same borrower secured by the same improved real estate could be deemed to be the functional equivalent of increasing the amount of the original loan. Therefore, if the original etermination was made not more than seven years before the date of the transaction, the basis of the determination was set forth on the SFHDF, and there were no map revisions or updates affecting the security property since the original determination was made, a lender may similarly rely on a previous determination if the lender makes multiple loans that are secured by the same building or mobile home. The Agencies have revised the proposed question and answer to also address subsequent loans by the same lender secured by the same improved real estate.

Section XIII. Flood Determination Fees

Proposed Section XIV (final Section XIII) consisted of proposed questions and answers 62 and 63 (final questions and answers 69 and 70 respectively), which addressed fees charged when making a flood determination and charging fees to cover life-of-loan monitoring of a loan, respectively. The Agencies received two comments on these questions and answers. One commenter supported them; the other commenter asked whether a lender could charge an up-front, nonrefundable, composite determination and life-of-loan fee regardless of whether the loan application closes. The Act and Regulation allow a lender to charge a reasonable fee for determining whether a building or mobile home securing a loan is located or will be located in a special flood hazard area if the determination is made in connection with the making, increasing, extending, or renewing of a loan that is initiated by the borrower. In the commenter's situation, the Agencies would agree that a fee for an initial determination could be charged when the determination is procured in connection with an application initiated by an applicant, even if the application does not close. However, a lender cannot charge a life-of-loan fee if the application does not close. Such a fee would be an unearned fee and, as such, charging such a fee would be prohibited by section 8 of RESPA. Therefore, a lender may not charge a nonrefundable, composite determination and life-of-loan fee when a loan application does not close. The Agencies have adopted the former question and answer as proposed. The Agencies have revised the latter question and answer in response to the comment.

Section XIV. Flood Zone Discrepancies

Proposed Section XV (final Section XIV) addressed flood zone discrepancies between the flood hazard designation documented by the lender on the SFHDF and the one documented on the flood insurance policy and used to rate the policy. There were numerous negative comments concerning the Agencies' proposed guidance for dealing with such discrepancies.

Proposed question and answer 64 (final question and answer 71) addressed lenders' recourse when confronted with a flood zone discrepancy. Nineteen commenters were generally opposed to the proposed treatment of a discrepancy as set forth in the proposed question and answer. Several of these commenters argued that the Act does not require lenders to identify and resolve flood zone discrepancies and ensure that a flood insurance policy is properly rated. Other commenters argued that it is an undue burden to expect financial institutions to resolve discrepancies between the SFHDF and the flood insurance policy. Six commenters maintained that it is an insurance agent's responsibility to determine the correct flood zone and that a lender should not be responsible for auditing an NFIP-authorized insurance agent. These commenters argued that requiring lenders to document every flood zone discrepancy would be costly and burdensome and require extensive loan servicing system changes.

Two commenters stated that the Agencies need to clearly define ``zone discrepancy.'' Another commenter asked what action would be required to correct any ``violation'' and further inquired how much flood insurance should be force placed in such a situation if a lender wants to correct a discrepancy by means of force placement. Two other commenters said that a borrower will not want to obtain a Letter of Determination Review from FEMA at a cost of $80 when there is a dispute between the lender and insurance company over a flood zone discrepancy, while three other commenters noted that it is unreasonable to expect the parties to wait 45 days for a FEMA determination review. Finally, two commenters noted that if a coverage error occurs, the borrower or lender may reconcile this through payment of the premium differential (the amount of premium that would have been charged if the policy had been correctly rated) or FEMA may reduce the amount of claim payment.

The Agencies disagree with those commenters who argued against a lender being responsible for resolving flood zone designation discrepancies, either as a legal matter or because the requirement would be burdensome and costly. The Agencies agree, and FEMA concurs, that Federal law places the ultimate responsibility to ensure appropriate flood insurance coverage on the lender. The Agencies note that, although coverage errors can be mitigated after a flood loss by paying premium differentials or reducing the claim payment, these mitigation techniques do not relieve a lender of the responsibility to ensure that an appropriate amount of flood insurance coverage is in place when a loan is made.

Commenters, however, raised valid points with respect to the proposed process for resolving flood zone [[Page 35930]] discrepancies. To address these points, the Agencies have revised final question and answer 71 to specify that lenders need only address discrepancies between high-risk zones (Zones A or V) and moderate- or low-risk zones (Zones B, C, D, or X). The revised question and answer further specifies the actions a lender should take if such a zone discrepancy is found to exist. Those steps continue to include attempting to determine whether the discrepancy is a result of a legitimate reason, such as grandfathering, or is a mistake. In certain circumstances, submitting a request for a Determination Review to FEMA may be an appropriate means of resolving discrepancies; however, it is not required in all situations. The question and answer explains that if the discrepancy is not resolved, the lender should send a letter to the insurance agent and/or the insurance company reminding them of FEMA's April 16, 2008, instruction that, in cases of determination discrepancies, the policy should be written to cover the higher risk zone. Beyond that, no further action by the lender is required. If, for its own purposes, the lender believes force placement is appropriate, then it should consult the guidance on that topic found in Sections II and X.

Proposed question and answer 65 (final question and answer 72), addressed whether lenders can be found in violation of the Act and Regulation for flood zone discrepancies. Seven commenters either registered their opposition to the proposed question and answer or recommended that it be deleted outright. These commenters argued, similar to their comments on proposed question and answer 64, that the lender is the wrong person to resolve flood zone discrepancies, that it is instead the responsibility of the insurance agent and the company issuing the flood insurance policy to ensure that the flood zone is correct, and that imposing this requirement on lenders is an unnecessary burden not mandated by law. Another commenter argued that by sanctioning lenders for not successfully identifying and resolving flood zone discrepancies, the two proposed questions and answers would create a duty to ensure that the flood policy is rated properly that does not presently exist under the Act or the Regulation.

As noted above, the Act and the Regulation require lenders to ensure that an appropriate amount of flood insurance coverage is purchased; lenders, therefore, should take steps to identify and address flood zone discrepancies. If a pattern or practice of unresolved discrepancies is found in a lender's loan portfolio, due to a lack of effort on the lender's part to resolve such discrepancies using the process outlined in final question and answer 71, the Agencies may cite the lender for a violation of the mandatory purchase requirements.

Section XV. Notice of Special Flood Hazards and Availability of Federal Disaster Relief

Proposed Section XVI (final Section XV) addressed the notice of special flood hazards and the availability of Federal disaster relief that lenders are generally required to provide to borrowers. The proposed questions and answers primarily proposed only minor wording changes or clarifications to questions and answers in the 1997 Interagency Questions and Answers without any change in the substance or meaning.

Proposed question and answer 66 (final question and answer 73), addressed whether the notice had to be provided to each borrower for each real estate related loan. The proposed answer explained that in a transaction involving multiple borrowers, the lender is only required to send notice to one borrower, but may provide multiple notices if the lender chooses. The Agencies received a comment on a related issue asking who should receive the notice if, at the time of increase, real estate collateral has been hypothecated by a guarantor as security on the borrower's loan. If a lender takes a security interest in improved real estate owned by a guarantor (not simply pledged by a guarantor) located in an SFHA, then flood insurance is required and the notice should be sent to both the borrower and the guarantor.

Another commenter asked when borrowers have to be notified that their secured property is in a flood zone. The commenter noted that their examiners have previously said ten days prior to loan closing. As noted in the Regulation, lenders are required to provide notice within a reasonable time before completion of the transaction (loan closing). What constitutes ``reasonable'' notice will necessarily vary according to the circumstances of particular transactions. Regulated lending institutions should bear in mind, however, that a borrower should receive notice timely enough to ensure that (1) the borrower has the opportunity to become aware of the borrower's responsibilities under the NFIP; and (2) where applicable, the borrower can purchase flood insurance before completion of the loan transaction. In light of these considerations, the final question and answer does not establish a fixed time period during which a lender must provide the notice to the borrower. The Agencies generally continue to regard ten days as a ``reasonable'' time interval. The Agencies adopt the question and answer as proposed.

Proposed question and answer 67 (final question and answer 74) addressed how the notice requirement applied to loans secured by mobile homes where the location of the mobile home may not be known until just prior to, or sometimes after, the loan closing. The Agencies did not receive any substantive comments and adopt the question and answer as proposed.

Proposed question and answer 68 (final question and answer 75), addressed when the lender is required to provide notice to the loan servicer that flood insurance is required. Proposed question and answer 69 (final question and answer 76) addressed what constitutes appropriate notice to the loan servicer. Proposed question and answer 70 (final question and answer 77) addressed whether it was necessary for the lender to provide notice to a loan servicer affiliated with the lender. Proposed question and answer 71 (final question and answer 78) addressed how long a lender has to maintain the record of receipt by the borrower of the notice. The Agencies received one comment that was supportive of these proposed questions and answers. The Agencies adopt the questions and answers as proposed.

Proposed question and answer 72 (final question and answer 79), addressed whether a lender can rely on a previous notice that is less than seven years old and was given to the same borrower for the same property by the same lender. Two commenters stated that lenders should be able to waive a notice to a borrower when they already have adequate flood insurance and one commenter said that notice should not be required when there has not been a change in the flood map. The Act and Regulation require lenders to send notice when a lender makes, increases, extends, or renews a loan secured by a building or a mobile home located or to be located in a special flood hazard area. Therefore, as a statutory requirement, the notice may not be waived.
The Agencies adopt the question and answer as proposed.

Proposed question and answer 73 (final question and answer 80), addressed whether the use of the sample form of notice is mandatory. The Agencies received one comment that was supportive of the proposed question and answer; however, another commenter asked whether lenders [[Page 35931]] should use the revised version of the Sample Form of the Notice
provided by FEMA in 2007 or the sample notice that accompanies the Regulation. The Agencies do not require the use of a specific form so long as the form contains the required information as specified by the Act and Regulation. The Agencies revised the answer, to reflect that the sample form of the notice provided by FEMA in its Mandatory Purchase of Flood Insurance Guidelines is also not required to be used.

Section XVI. Mandatory Civil Money Penalties

Proposed Section XVII (final Section XVI) addressed the imposition of mandatory civil money penalties for violations of the flood insurance requirements. Proposed question and answer 74 (final question and answer 81) listed the sections of the Act that trigger mandatory civil money penalties when examiners find a pattern or practice of violations of those sections and included information about statutory limits on the amount of such penalties. The Agencies did not receive any comments and adopt the question and answer as proposed.

Proposed question and answer 75 (final question and answer 82) addressed the general standards the Agencies consider when determining whether violations constitute a pattern or practice for which civil money penalties are mandatory. The Agencies received one industry trade group comment suggesting that proposed question and answer 75 be amended to clarify that the assessment of civil money penalties be based on an overall assessment of the entire loan portfolio and not randomly selected representations. The Agencies believe that the guidance in this question and answer properly sets forth the general standards the Agencies consider when determining whether a pattern or practice of violations has occurred. As discussed in the March 2008 Proposed Interagency Questions and Answers, the considerations listed in the proposed question and answer are not dispositive of individual cases, but serve as a reference point for reviewing the particular
facts and circumstances. The Agencies adopt the question and answer as proposed.

Redesignation Table

The following redesignation table is provided as an aid to assist the public in reviewing the revisions to the 1997 Interagency Questions and Answers.

1997 Interagency   Current questions and answers

questions and answers
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Section I. Definitions.................... ....
Section I, Question 1..................... Section IV, Question 20.
Section I, Question 2..................... Section IV, Question 19.
Section I, Question 3..................... Section VII, Question 34.
Section I, Question 4..................... Section VII, Question 35.
Section I, Question 5..................... Section VII, Question 38.
Section I, Question 6..................... Section VII, Question 39; and Section VII, Question 40.
Section I, Question 7..................... Section VII, Question 41.
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Section II. Requirement
to Purchase Flood
Insurance Where Available. ....
Section II, Question 1.................... Section I, Question 1.
Section II, Question 2.................... Section I, Question 3.
Section II, Question 3.................... Section I, Question 6.
Section II, Question 4.................... Deleted as obsolete.
Section II, Question 5.................... Section II, Question 15.
Section II, Question 6.................... Section VIII, Question 44.
Section II, Question 7.................... Section II, Question 14; and Section V, Question 25.
Section II, Question 8.................... Section VI, Question 28.
Section II, Question 9.................... Section VI, Question 31.
Section III. Exemptions................... Section III. Exemptions from the mandatory flood insurance requirements.
Section III, Question 1................... Section III, Question 18.
Section IV. Escrow .... Section IX. Escrow requirements.
Requirements
Section IV, Question 1.................... Deleted as obsolete.
Section IV, Question 2.................... Section IX, Question 51.
Section IV, Question 3.................... Section IX, Question 52.
Section IV, Question 4.................... Section IX, Question 53.
Section IV, Question 5.................... Section IX, Question 54.
Section IV, Question 6.................... Section IX, Question 55.
Section IV, Question 7.................... Section IX, Question 56.
Section V. Required Use................ Section XII. Required use of Standard Flood Hazard Determination Form (SFHDF).
of Standard Flood
Hazard Determination
Form (SFHDF).
Section V, Question 1..................... Section XII, Question 65.
Section V, Question 2..................... Section XII, Question 66.
Section V, Question 3..................... Section XII, Question 67.
Section V, Question 4..................... Section XII, Question 68.
Section V, Question 5..................... Section VII, Question 36; and Section VII, Question 37
Section VI. Force Placement.......... Section X. Force placement of flood insurance.
of Flood Insurance.
Section VI, Question 1.................... Section X, Question 57.

Section VI, Question 2.................... Section X, Question 58.
Section VI, Question 3.................... Section X, Question 59.
Section VII. Determination Fees...... Section XIII. Flood determination fees.
Section VII Question 1.................... Section XIII, Question 69.
Section VII Question 2.................... Section XIII, Question 70.
Section VIII. Notice of Special........ Section XV. Notice of special flood hazards and availability of Federal disaster relief.
Flood Hazards and Availability
of Federal Disaster Relief.
Section VIII, Question 1.................. Section XV, Question 73
Section VIII, Question 2.................. Section XV, Question 74.
Section VIII, Question 3.................. Section XV, Question 75.
Section VIII, Question 4.................. Section XV, Question 76.
Section VIII, Question 5.................. Section XV, Question 77.
Section VIII, Question 6.................. Section XV, Question 78.
Section IX. Notice of .... Section VIII. Flood insurance requirements in the event of the sale or transfer of a designated loan and/or its servicing rights.
Servicer's Identity.
Section IX, Question 1.................... Section VIII, Question 45.
Section IX, Question 2.................... Section VIII, Question 46.
Section IX, Question 3.................... Section VIII, Question 47.
Section IX, Question 4.................... Section VIII, Question 48.
Section IX, Question 5.................... Section VIII, Question 49.
Section IX, Question 6.................... Section VIII, Question 50.
Section X Appendix A .... Section XV. Notice of special flood hazards and availability of Federal disaster relief.
to the Regulation-- Sample Form
of Notice of Special Flood
Hazards and Availability of Federal
Disaster Relief Assistance.
Section X, Question 1..................... Section XV, Question 80.

Proposed Questions and Answers and Request for Comment

The Agencies are proposing five new questions and answers for public [[Page 35932]] comment upon consideration of various comments received on the March 2008 Proposed Interagency Questions and Answers. The new proposed questions and answers concern the determination of insurable value in calculating the maximum limit of coverage available for the particular type of property under the Act and force placement of required flood insurance. In anticipation of the possible adoption of these proposed questions and answers, the applicable question and answer numbers have been reserved and the remaining questions and answers have been renumbered accordingly.

Insurable value. The Agencies received numerous comments to proposed question and answer 7 stating that implementing insurable value was confusing and that the term needed clear and objective standards. Commenters asked for guidance on the terms ``overall value'' and ``repair or replacement cost'' as they relate to a lender's determination of the required amount of flood insurance for a designated loan. Commenters similarly asked the Agencies to define the term ``actual cash value.'' In response to these comments, the Agencies are proposing new questions and answers 9 and 10 for public comment to address how to calculate insurable value. Calculating insurable value is important because in addition to

the maximum caps under the Act, the
Regulation provides that ``flood insurance coverage under the Act is limited to the overall value of the property securing the designated loan minus the value of the land on which the property is located." The Agencies use the term ``insurable value" in the proposed question and answer to mean the overall value minus the value of the land.

FEMA guidelines state that the full insurable value of a building is the same as 100 percent replacement cost value (RCV) of the insured building.\9\ Replacement cost value, according to FEMA's Mandatory Purchase of Flood Insurance Guidelines, is the cost to replace property with the same kind of material and construction without deduction for depreciation.\10\ As such, it is important to make clear that the RCV of a building is not its contributory value to the overall appraised value of the collateral and does not include any value for any land that is also part of collateral. When determining the RCV of a building, lenders (either by themselves or in consultation with the flood insurance provider or other professionals) should consider the
replacement cost value under a hazard insurance policy, an appraisal based on a cost-value before depreciation deductions (not a market-value) approach, and/or a construction cost calculation.

\9\ FEMA, Mandatory Purchase of Flood Insurance Guidelines, at 27.
\10\ FEMA, Mandatory Purchase of Flood Insurance Guidelines, at GLS10.

The statutory and regulatory requirement that flood insurance be obtained in the amount of the lesser of the principal balance of the designated loan or the maximum limit of coverage available for the particular type of building under the Act is separate from the amount of a recovery if the improved property is destroyed by flood. Insurable value is replacement cost value and would be the amount required for adequate insurance coverage assuming that amount does not exceed the principal balance of the designated loan or the maximum limit of coverage under the Act. Actual cash value, which would be determined by a claims adjuster at the time of loss, is the amount that will be paid by the NFIP for nonresidential properties and certain residential properties. To lessen the effect of a potential difference between the two values with certain nonresidential buildings, the Agencies, with FEMA's concurrence, are proposing new questions and answers 9 and 10.

It is important for lenders to recognize that insurable value is only relevant to the extent that it is lower than either the outstanding principal balance of the loan or the maximum amount of
insurance available under the NFIP. Therefore, if the insurable value of a building is the lesser of the outstanding principal balance of the loan or the maximum amount of insurance allowable under the NFIP, then the building must be insured at its insurable value, which for single family, 2-4 family, other residential or nonresidential buildings, is equivalent to its RCV. The Agencies are proposing new question and answer 9 to provide more concrete guidance on insurable value.

9. What is the insurable value of a building?

Answer: Per FEMA guidelines, the insurable value of a building is the same as 100 percent replacement cost value of the insured building. FEMA's Mandatory Purchase of Flood Insurance Guidelines defines replacement cost as ``The cost to replace property with the same kind of material and construction without deduction for depreciation." When determining replacement cost value of a building, lenders (either by themselves or in consultation with the flood insurance provider or other professionals) should consider the replacement cost value used in a hazard insurance policy (recognizing that replacement cost for flood insurance will include the foundation), an appraisal based on a cost-value approach before depreciation deductions (not a market-value), and/or a construction cost calculation.

In considering the comments submitted on the subject of insurable value, the Agencies recognized that there are situations when insuring some nonresidential buildings at RCV would result in the building being over-insured. The Agencies, in consultation with FEMA, are proposing two alternatives to determine replacement cost value for nonresidential buildings used for ranching, farming, or industrial purposes, which the borrower either would not replace if damaged or destroyed by a flood or would replace with a structure more closely aligned to the function the building is providing at the time of the flood. Industrial use, as opposed to the broader commercial use, is defined as those buildings not directly engaged in the retail and/or wholesale sale of the business's goods, such as warehouses or storage, manufacturing, or maintenance facilities.

The first alternative is the ``functional building cost value,'' which is the cost to repair or replace a building with commonly used, less costly construction materials and methods that are functionally equivalent to obsolete, antique, or custom construction materials and methods used in the original construction of the building. Borrowers and/or lenders can choose this alternative when the building being insured is important to the business operation and would be replaced if damaged or destroyed by a flood, but not to its original condition. The ``functional building cost value'' recognizes that insurance to the replacement cost is not needed as the borrower would not repair or replace the building back to its original form but to a condition that represents the function the building is providing to the business operation.

The second alternative is the ``demolition/removal cost value,'' which is the cost to demolish the remaining structure and remove the debris after a flood. Borrowers and/or lenders can choose this alternative when the building being insured is not important to the business operation and would not be repaired or replaced if damaged or destroyed by a flood. The ``demolition/removal cost value'' recognizes that the building has limited-to-no-value and [[Page 35933]] that it does not provide an important enough function to necessitate that the business repair or replace it.

When a borrower or lender chooses one of these two replacement cost value alternatives they have determined that the building to be insured will not be insured to its full replacement cost value. Both the borrower and the lender should ensure that they consider the impact this may have on the ongoing nature of the business and the value of the collateral securing the loan. Full replacement cost is always the preferred insurance amount. These alternatives are available only for those situations where full replacement cost would result in a building used for farming, ranching, or industrial purposes being over-insured. The Agencies are proposing new question and answer 10 to address this issue.

10. Are there alternative approaches to determining the insurable value of a building?

Answer: Yes, in the case of buildings used for ranching, farming, and industrial purposes, insurable value may also be determined by the functional building cost value or the demolition/removal cost value. The Agencies recognize that there are situations where insuring some nonresidential buildings to the replacement cost value will result in the building being over-insured. Therefore, borrowers and/or lenders have two alternative approaches to determine the insurable value for buildings used in ranching, farming, and for industrial purposes when the borrower would either not replace the building if damaged or destroyed by a flood or would replace the building with a structure more closely aligned with the function the building is presently providing. Industrial use, as opposed to the broader commercial use, means those buildings not directly engaged in the retail and/or wholesale sale of the business's goods, such as warehouses, storage, manufacturing, or maintenance facilities.

The lender may calculate the insurable value as the ``functional building cost value,'' that is, the cost to replace a building with a lower-cost functional equivalent. The ``functional building cost value'' is the cost to repair or replace a building with commonly used, less costly construction materials and methods that are functionally equivalent to obsolete, antique, or custom construction materials and methods used in the original construction of the building. The determination of the appropriate ``functional building cost value'' amount of insurance should be made by the lender and/or borrower. This alternative may be chosen when the building is important to the ongoing nature of the business and would be replaced if damaged or destroyed in a flood, but not to its original form. For example, a farming operation would replace an old dairy barn currently used for storage with a storage building of pole, or some other type of less costly construction found currently in storage buildings.

The lender may calculate the insurable value as the ``demolition/removal cost value,'' that is the cost to demolish the remaining structure and remove the debris. The ``demolition/removal cost value'' may be used when a building is not important to the ongoing nature of the business and as such would not be replaced if damaged or destroyed by a flood. The amount of flood insurance should be calculated by the lender and/or borrower to be at least the cost of demolition and removal of the insured debris.

Regardless of what method the lender and/or borrower selects to determine insurable value (replacement cost value or one of the two alternatives), all terms and conditions of the Standard Flood Insurance Policy apply including its Loss Settlement provision.

Force placement. In response to comments received regarding the force placement of flood insurance, the Agencies are proposing new questions and answers 60, 61, and 62, which would be added to Section X to address the following force-placement issues: whether a borrower may be charged for the cost of flood insurance coverage during the 45-day notice period, when the 45-day notice period should begin, and how soon a lender should take action after learning that improved real estate that secures a loan is uninsured or under-insured.

Several commenters requested clarification regarding timing issues related to the 45-day notice. One commenter requested clarification on whether the 45-day notice could be sent prior to the actual date of expiration of flood insurance coverage. The Act and Regulation require the lender, or its servicer, to send notice to the borrower upon making a determination that the improved real estate collateral's insurance coverage has expired or is less than the amount required for that particular property, such as upon receipt of the notice of cancellation or expiration from the insurance provider or as a result of an internal flood policy monitoring system. The borrower must obtain flood insurance within 45 days after notification by the lender; however, the 45-day period cannot begin until the lender or servicer has sent notice to the borrower. Furthermore, the Act does not permit a lender or its servicer to send the 45-day notice to the borrower prior to the actual expiration date of the flood insurance policy.

Another commenter suggested that flood insurance be force placed through private insurers since this would allow flood insurance coverage to be immediately available instead of having to wait 45 days. Whether the lender plans to force place coverage through FEMA or private insurers, lenders must allow the borrower 45 days in which to obtain flood insurance. The Agencies are proposing new question and answer 60 to address these commenters' issues.

60. Can the 45-day notice period be accelerated by sending notice to the borrower prior to the actual date of expiration of flood insurance coverage?

Answer: No. Although a lender or servicer may send a notice warning a borrower that flood insurance on the collateral is about to expire, the Act and Regulation do not allow a lender or its servicer to shorten the 45-day force-placement notice period by sending notice to the borrower prior to the actual expiration date of the flood insurance policy. The Act provides that a lender or its servicer must notify a borrower if it determines that the improved real estate collateral's insurance coverage has expired or is less than the amount required for that particular property. 42 U.S.C. 4012a(e). A lender must send the notice upon making a determination that the flood insurance coverage is inadequate or has expired, such as upon receipt of the notice of cancellation or expiration from the insurance provider or as a result of an internal flood policy monitoring system. This notice must allow the borrower 45 days in which to obtain flood insurance.

Three commenters asserted that it would be appropriate for the Agencies to allow a reasonable period to implement force placement after the end of the 45-day notice period. The Regulation provides that the lender or its servicer shall purchase insurance on the borrower's behalf if the borrower fails to obtain flood insurance within 45 days after notification. Given that the lender is already aware during the 45-day notice period that it may be required to force place insurance if there is no response from the borrower, any delay should be brief. Where there is a brief delay in force placing required insurance, the Agencies will expect the lender to provide a reasonable explanation for the delay. The Agencies [[Page 35934]] are proposing new question and answer 61 to address these commenters' concern.

One commenter suggested that a lender's procurement of the flood insurance binder should be acceptable under the Act and Regulation to satisfy the force placement requirement. The Agencies believe that the insurance binder may provide a reasonable explanation for a delay in force placing the formal flood insurance policy. However, an insurance binder is proof only of temporary coverage for a limited period of time until the formal insurance policy is either accepted or denied. Lenders should have sufficient internal controls in place to ensure that if a formal policy is not issued, it should force place required insurance immediately.

61. When must the lender have flood insurance in place if the borrower has not obtained adequate insurance within the 45-day notice period?

Answer: The Regulation provides that the lender or its servicer shall purchase insurance on the borrower's behalf if the borrower fails to obtain flood insurance within 45 days after notification. However, where there is a brief delay in force placing required insurance, the Agencies will expect the lender to provide a reasonable explanation for the delay.

Two commenters asked whether it is permissible to charge a borrower for the cost of insurance during all or a portion of the 45-day notice period. Regardless of whether the flood insurance coverage is obtained through FEMA or by private means, under the Act and Regulation, lenders may not impose the cost of coverage for that 45-day period at any time. The Agencies are proposing new question and answer 62 to address this comment.

62. Does a lender or its servicer have the authority to charge a borrower for the cost of insurance coverage during the 45-day notice period?

Answer: No. There is no authority under the Act and Regulation to charge a borrower for a force-placed flood insurance policy until the 45-day notice period has expired. The ability to impose the costs of force placed flood insurance on a borrower commences 45 days after notification to the borrower of a lack of insurance or of inadequate insurance coverage. Therefore, lenders may not charge borrowers for coverage during the 45-day notice period. This holds true regardless of whether the force placed flood insurance is obtained through the NFIP or a private provider.

Public Comments

The Agencies specifically invite public comment on the proposed new questions and answers. If financial institutions, bank examiners, community groups, or other interested parties have unanswered questions or comments about the Agencies' flood insurance regulation, they should submit them to the Agencies. The Agencies will consider including these questions and answers in future guidance.

Solicitation of Comments Regarding the Use of ``Plain Language''

Section 722 of the Gramm-Leach-Bliley Act of 1999, 12 U.S.C. 4809, requires the Federal banking Agencies to use ``plain language'' in all proposed and final rules published after January 1, 2000. Although this document is not a proposed rule, comments are nevertheless invited on whether the proposed questions and answers are stated clearly and how they might be revised to be easier to read.

The text of the Interagency Questions and Answers follows:

Interagency Questions and Answers Regarding Flood Insurance

The Interagency Questions and Answers are organized by topic. Each topic addresses a major area of the Act and Regulation. For ease of reference, the following terms are used throughout this document: ``Act'' refers to the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973, as revised by the National Flood Insurance Reform Act of 1994 (codified at 42 U.S.C. 4001 et seq.). ``Regulation'' refers to each agency's current final rule.\11\ The OCC, Board, FDIC, OTS, NCUA, and FCA (collectively, ``the Agencies'') are providing answers to questions pertaining to the following topics:

\11\ The Agencies' rules are codified at 12 CFR part 22 (OCC), 12 CFR part 208 (Board), 12 CFR part 339 (FDIC), 12 CFR part 572 (OTS), 12 CFR part 614 (FCA), and 12 CFR part 760 (NCUA).

I. Determining When Certain Loans Are Designated Loans for Which Flood Insurance Is Required Under the Act and Regulation

II. Determining the Appropriate Amount of Flood Insurance Required Under the Act and Regulation

III. Exemptions From the Mandatory Flood Insurance Requirements

IV. Flood Insurance Requirements for Construction Loans

V. Flood Insurance Requirements for Nonresidential Buildings

VI. Flood Insurance Requirements for Residential Condominiums

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I. Determining When Certain Loans Are Designated Loans for Which Flood Insurance Is Required Under the Act and Regulation

1. Does the Regulation apply to a loan where the building or mobile home securing such loan is located in a community that does not participate in the National Flood Insurance Program (NFIP)?

Answer: Yes. The Regulation does apply; however, a lender need not require borrowers to obtain flood insurance for a building or mobile home located in a community that does not participate in the NFIP, even if the building or mobile home securing the loan is located in a Special Flood Hazard Area (SFHA). Nonetheless, a lender, using the standard Special Flood Hazard Determination Form (SFHDF), must still determine whether the building or mobile home is located in an SFHA. If the building or mobile home is determined to be located in an SFHA, a lender is required to notify the borrower. In this case, a lender, generally, may make a conventional loan without requiring flood insurance, if it chooses to do so. However, a lender may not make a government-guaranteed or insured loan, such as a Small Business Administration, Veterans Administration, or Federal Housing Administration loan secured by a building or mobile home located in an SFHA in a community that does not participate in the NFIP. See 42 U.S.C. 4106(a). Also, a lender is responsible for exercising sound risk management practices to ensure that it does not make a loan secured by
a building or mobile home located in an SFHA where no flood insurance is available, if doing so would be an unacceptable risk.

2. What is a lender's responsibility if a particular building or mobile home that secures a loan, due to a map change, is no longer located within an SFHA?

Answer: The lender is no longer obligated to require mandatory flood insurance; however, the borrower can [[Page 35935]] elect to convert the existing NFIP policy to a Preferred Risk Policy. For risk management purposes, the lender may, by contract, continue to require flood insurance coverage.

3. Does a lender's purchase of a loan, secured by a building or mobile home located in an SFHA in which flood insurance is available under the Act, from another lender trigger any requirements under the Regulation?

Answer: No. A lender's purchase of a loan, secured by a building or mobile home located in an SFHA in which flood insurance is available under the Act, alone, is not an event that triggers the Regulation's requirements, such as making a new flood determination or requiring a borrower to purchase flood insurance. Requirements under the Regulation, generally, are triggered when a lender makes, increases, extends, or renews a designated loan. A lender's purchase of a loan does not fall within any of those categories.

However, if a lender becomes aware at any point during the life of a designated loan that flood insurance is required, the lender must comply with the Regulation, including force placing insurance, if necessary. Depending upon the circumstances, safety and soundness considerations may sometimes necessitate such due diligence upon purchase of a loan as to put the lender on notice of lack of adequate flood insurance. If the purchasing lender subsequently extends, increases, or renews a designated loan, it must also comply with the Regulation.

4. How do the Agencies enforce the mandatory purchase requirements under the Act and Regulation when a lender participates in a loan syndication or participation?

Answer: As with purchased loans, the acquisition by a lender of an interest in a loan either by participation or syndication after that loan has been made does not trigger the requirements of Act or Regulation, such as making a new flood determination or requiring a borrower to purchase flood insurance. Nonetheless, as with purchased loans, depending upon the circumstances, safety and soundness considerations may sometimes necessitate that the lender undertake due diligence to protect itself against the risk of flood or other types of loss.

Lenders who pool or contribute funds that will be simultaneously advanced to a borrower or borrowers as a loan secured by improved real estate would all be subject to the requirements of Act or Regulation. Federal flood insurance requirements would also apply to those situations where such a group of lenders decides to extend, renew or increase a loan. Although the agreement among the lenders may assign compliance duties to a lead lender or agent, and include clauses in which the lead lender or agent indemnifies participating lenders against flood losses, each participating lender remains individually responsible for ensuring compliance with the Act and Regulation. Therefore, the Agencies will examine whether the regulated institution/participating lender has performed upfront due diligence to ensure both that the lead lender or agent has undertaken the necessary activities to ensure that the borrower obtains appropriate flood insurance and that the lead lender or agent has adequate controls to monitor the loan(s) on an ongoing basis for compliance with the flood insurance requirements. Further, the Agencies expect the participating lender to
have adequate controls to monitor the activities of the lead lender or agent to ensure compliance with flood insurance requirements over the term of the loan.

5. Does the Regulation apply to loans that are being restructured or modified?

Answer: It depends. If the loan otherwise meets the definition of a designated loan and if the lender increases the amount of the loan, or extends or renews the terms of the original loan, then the Regulation applies.

6. Are table funded loans treated as new loan originations?

Answer: Yes. Table funding, as defined under HUD's Real Estate Settlement Procedure Act (RESPA) rule, 24 CFR 3500.2, is a settlement at which a loan is funded by a contemporaneous advance of loan funds and the assignment of the loan to the person advancing the funds. A loan made through a table funding process is treated as though the party advancing the funds has originated the loan. The funding party is required to comply with the Regulation. The table funding lender can meet the administrative requirements of the Regulation by requiring the party processing and underwriting the application to perform those functions on its behalf.

7. Is a lender required to perform a review of its, or of its servicer's, existing loan portfolio for compliance with the flood insurance requirements under the Act and Regulation?

Answer: No. Apart from the requirements mandated when a loan is made, increased, extended, or renewed, a regulated lender need only review and take action on any part of its existing portfolio for safety and soundness purposes, or if it knows or has reason to know of the need for NFIP coverage. Regardless of the lack of such requirement in the Act and Regulation, however, sound risk management practices may lead a lender to conduct scheduled periodic reviews that track the need for flood insurance on a loan portfolio.

II. Determining the Appropriate Amount of Flood Insurance Required Under the Act and Regulation

8. The Regulation states that the amount of flood insurance required ``must be at least equal to the lesser of the outstanding principal balance of the designated loan or the maximum limit of coverage available for the particular type of property under the Act.'' What is meant by the ``maximum limit of coverage available for the particular type of property under the Act''?

Answer: ``The maximum limit of coverage available for the particular type of property under the Act'' depends on the value of the secured collateral. First, under the NFIP, there are maximum caps on the amount of insurance available. For single-family and two-to-four family dwellings and other residential buildings located in a participating community under the regular program, the maximum cap is $250,000. For nonresidential structures located in a participating community under the regular program, the maximum cap is $500,000. (In participating communities that are under the emergency program phase, the caps are $35,000 for single-family and two-to-four family dwellings and other residential structures, and $100,000 for nonresidential structures).

In addition to the maximum caps under the NFIP, the Regulation also provides that ``flood insurance coverage under the Act is limited to the overall value of the property securing the designated loan minus the value of the land on which the property is located,'' which is commonly referred to as the ``insurable value'' of a structure. The NFIP does not insure land; therefore, land values should not be included in the calculation.

An NFIP policy will not cover an amount exceeding the ``insurable value'' of the structure. In determining coverage amounts for flood insurance, lenders often follow the same practice used to establish other hazard insurance coverage amounts. However, unlike the insurable valuation used to underwrite most other hazard insurance policies, the insurable value of improved real
[[Page 35936]] estate for flood insurance purposes also includes the repair or replacement cost of the foundation and supporting structures. It is very important to calculate the correct insurable value of the property; otherwise, the lender might inadvertently require the borrower to purchase too much or too little flood insurance coverage. For example, if the lender fails to exclude the value of the land when determining the insurable value of the improved real estate, the borrower will be asked to purchase coverage that exceeds the amount the NFIP will pay in the event of a loss. (Please note, however, when taking a security interest in improved real estate where the value of the land, excluding the value of the improvements, is sufficient collateral for the debt, the lender must nonetheless require flood insurance to cover the value of the structure if it is located in a participating community's SFHA).

9. What is insurable value?

Answer: [Reserved]

10. Are there any alternatives to the definition of insurable value?

Answer: [Reserved]

11. What are examples of residential buildings?

Answer: Residential buildings include one-to-four family dwellings; apartment or other residential buildings containing more than four dwelling units; condominiums and cooperatives in which at least 75 percent of the square footage is residential; hotels or motels where the normal occupancy of a guest is six months or more; and rooming houses that have more than four roomers. A residential building may have incidental nonresidential use, such as an office or studio, as long as the total area of such incidental occupancy is limited to less than 25 percent of the square footage of the building, or 50 percent for single-family dwellings.

12. What are examples of nonresidential buildings?

Answer: Nonresidential buildings include those used for small businesses, churches, schools, farm activities (including grain bins and silos), pool houses, clubhouses, recreation, mercantile structures, agricultural and industrial structures, warehouses, hotels and motels with normal room rentals for less than six months' duration, nursing homes, and mixed-use buildings with less than 75 percent residential square footage.

13. How much insurance is required on a building located in an SFHA in a participating community?

Answer: The amount of insurance required by the Act and Regulation is the lesser of:

The outstanding principal balance of the loan(s); or

The maximum amount of insurance available under the NFIP, which is the lesser of:

The maximum limit available for the type of structure; or

The ``insurable value'' of the structure.

Example: (Calculating insurance required on a nonresidential building):

Loan security includes one equipment shed located in an SFHA in a participating community under the regular program.

Outstanding loan principal is $300,000.

Maximum amount of insurance available under the NFIP:

Maximum limit available for type of structure is $500,000 per building (nonresidential building).

Insurable value of the equipment shed is $30,000.

The minimum amount of insurance required by the Regulation for the equipment shed is $30,000.

14. Is flood insurance required for each building when the real estate security contains more than one building located in an SFHA in a participating community? If so, how much coverage is required?

Answer: Yes. The lender must determine the amount of insurance required on each building and add these individual amounts together. The total amount of required flood insurance is the lesser of:

The outstanding principal balance of the loan(s); or

The maximum amount of insurance available under the NFIP, which is the lesser of:

The maximum limit available for the type of structures; or

The ``insurable value'' of the structures.

The amount of total required flood insurance can be allocated among the secured buildings in varying amounts, but all buildings in an SFHA must have some coverage.

Example: Lender makes a loan in the principal amount of $150,000 secured by five nonresidential buildings, only three of which are located in SFHAs within participating communities.

Outstanding loan principal is $150,000.

Maximum amount of insurance available under the NFIP.

Maximum limit available for the type of structure is $500,000 per building (nonresidential buildings); or

Insurable value (for each nonresidential building for which insurance is required, which is $100,000, or $300,000 total).

Amount of insurance required for the three buildings is $150,000. This amount of required flood insurance could be allocated among the three buildings in varying amounts, so long as each is covered by flood insurance.

15. If the insurable value of a building or mobile home, located in an SFHA in which flood insurance is available under the Act, securing a designated loan is less than the outstanding principal balance of the loan, must a lender require the borrower to obtain flood insurance up to the balance of the loan?

Answer: No. The Regulation provides that the amount of flood insurance must be at least equal to the lesser of the outstanding principal balance of the designated loan or the maximum limit of coverage available for a particular type of property under the Act. The Regulation also provides that flood insurance coverage under the Act is limited to the overall value of the property securing the designated loan minus the value of the land on which the building or mobile home is located. Since the NFIP policy does not cover land value, lenders should determine the amount of insurance necessary based on the insurable value of the improvements.

16. Can a lender require more flood insurance than the minimum required by the Regulation?

Answer: Yes. Lenders are permitted to require more flood insurance coverage than required by the Regulation. The borrower or lender may have to seek such coverage outside the NFIP. Each lender has the responsibility to tailor its own flood insurance policies and procedures to suit its business needs and protect its ongoing interest in the collateral. However, lenders should avoid creating situations where a building is ``over-insured.''

17. Can a lender allow the borrower to use the maximum deductible to reduce the cost of flood insurance?

Answer: Yes. However, it is not a sound business practice for a lender to allow the borrower to use the maximum deductible amount in every situation. A lender should determine the reasonableness of the deductible on a case-by-case basis, taking into account the risk that such a deductible would pose to the borrower and lender. A lender may not allow the borrower to use a deductible amount equal to the insurable value of the property to avoid [[Page 35937]] the mandatory purchase requirement for flood insurance.

III. Exemptions From the Mandatory Flood Insurance Requirements

18. What are the exemptions from coverage?

Answer: There are only two exemptions from the purchase requirements. The first applies to State-owned property covered under a policy of self-insurance satisfactory to the Director of FEMA. The second applies if both the original principal balance of the loan is $5,000 or less, and the original repayment term is one year or less.

IV. Flood Insurance Requirements for Construction Loans

19. Is a loan secured only by land that is located in an SFHA in which flood insurance is available under the Act and that will be developed into buildable lot(s) a designated loan that requires flood insurance?

Answer: No. A designated loan is defined as a loan secured by a building or mobile home that is located or to be located in an SFHA in which flood insurance is available under the Act. Any loan secured only by land that is located in an SFHA in which flood insurance is available is not a designated loan since it is not secured by a building or mobile home.

20. Is a loan secured or to be secured by a building in the course of construction that is located or to be located in an SFHA in which flood insurance is available under the Act a designated loan?

Answer: Yes. Therefore, a lender must always make a flood determination prior to loan origination to determine whether a building to be constructed that is security for the loan is located or will be located in an SFHA in which flood insurance is available under the Act. If so, then the loan is a designated loan and the lender must provide the requisite notice to the borrower prior to loan origination that mandatory flood insurance is required. The lender must then comply with the mandatory purchase requirement under the Act and Regulation.

21. Is a building in the course of construction that is located in an SFHA in which flood insurance is available under the Act eligible for coverage under an NFIP policy?

Answer: Yes. FEMA's Flood Insurance Manual, under general rules, states:

Buildings in the course of construction that have yet to be walled and roofed are eligible for coverage except when construction has been halted for more than 90 days and/or if the lowest floor used for rating purposes is below the Base Flood Elevation (BFE). Materials or supplies intended for use in such construction, alteration, or repair are not insurable unless they are contained within an enclosed building on the premises or adjacent to the premises.

FEMA, Flood Insurance Manual at p. GR 4 (FEMA's Flood Insurance Manual is updated every six months). The definition section of the Flood Insurance Manual defines ``start of construction'' in the case of new construction as ``either the first placement of permanent construction of a building on site, such as the pouring of a slab or footing, the installation of piles, the construction of columns, or any work beyond the stage of excavation; or the placement of a manufactured (mobile) home on a foundation.'' FEMA, Flood Insurance Manual, at p. DEF 9. While an NFIP policy may be purchased prior to the start of construction, as a practical matter, coverage under an NFIP policy is not effective until actual construction commences or when materials or supplies intended for use in such construction, alteration, or repair are contained in an enclosed building on the premises or adjacent to the premises.

22. When must a lender require the purchase of flood insurance for a loan secured by a building in the course of construction that is located in an SFHA in which flood insurance is available?

Answer: Under the Act, as implemented by the Regulation, a lender may not make, increase, extend, or renew any loan secured by a building or a mobile home, located or to be located in an SFHA in which flood insurance is available, unless the property is covered by adequate flood insurance for the term of the loan. One way for lenders to comply with the mandatory purchase requirement for a loan secured by a building in the course of construction that is located in an SFHA is to require borrowers to have a flood insurance policy in place at the time of loan origination.

Alternatively, a lender may allow a borrower to defer the purchase of flood insurance until either a foundation slab has been poured and/or an elevation certificate has been issued or, if the building to be constructed will have its lowest floor below the Base Flood Elevation, when the building is walled and roofed.\12\ However, the lender must require the borrower to have flood insurance in place before the lender disburses funds to pay for building construction (except as necessary to pour the slab or perform preliminary site work, such as laying utilities, clearing brush, or the purchase and/or delivery of building materials) on the property securing the loan. If the lender elects this approach and does not require flood insurance to be obtained at loan origination, then it must have adequate internal controls in place at origination to ensure that the borrower obtains flood insurance no later than when the foundation slab has been poured and/or an elevation
certificate has been issued.

\12\ FEMA, Mandatory Purchase of Flood Insurance Guidelines, at 30.

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23. Does the 30-day waiting period apply when the purchase of the flood insurance policy is deferred in connection with a construction loan?

Answer: No. The NFIP will rely on an insurance agent's representation on the application for flood insurance that the purchase of insurance has been properly deferred unless there is a loss during the first 30 days of the policy period. In that case, the NFIP will require documentation of the loan transaction, such as settlement papers, before adjusting the loss.

V. Flood Insurance Requirements for Nonresidential Buildings

24. Some borrowers have buildings with limited utility or value and, in many cases, the borrower would not replace them if lost in a flood. Is a lender required to mandate flood insurance for such buildings?

Answer: Yes. Under the Regulation, lenders must require flood insurance on real estate improvements when those improvements are part of the property securing the loan and are located in an SFHA and in a participating community.

The lender may consider ``carving out'' buildings from the security it takes on the loan. However, the lender should fully analyze the risks of this option. In particular, a lender should consider whether it would be able to market the property securing its loan in the event of foreclosure. Additionally, the lender should consider any local zoning issues or other issues that would affect its collateral.

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25. What are a lender's requirements under the Regulation for a loan secured by multiple buildings located throughout a large geographic area where some of the buildings are located in an SFHA in which flood insurance is available and other buildings are not? What if the buildings are located in several jurisdictions or counties where some of the communities participate in the NFIP and others do not?

Answer: A lender is required to make a determination as to whether the improved real property securing the loan is in an SFHA. If secured improved real estate is located in an SFHA, but not in a participating community, no flood insurance is required, although a lender can require the purchase of flood insurance (from a private insurer) as a matter of safety and soundness. Conversely, where secured improved real estate is located in a participating community but not in an SFHA, no insurance is required. A lender must provide appropriate notice and require the purchase of flood insurance for designated loans located in an SFHA in a participating community.

VI. Flood Insurance Requirements for Residential Condominiums

26. Are residential condominiums, including multi-story condominium complexes, subject to the statutory and regulatory requirements for flood insurance?

Answer: Yes. The mandatory flood insurance purchase requirements under the Act and Regulation apply to loans secured by individual residential condominium units, including those located in multi-story condominium complexes, located in an SFHA in which flood insurance is available under the Act. The mandatory purchase requirements also apply to loans secured by other condominium property, such as loans to a developer for construction of the condominium or loans to a condominium association.

27. What is an NFIP Residential Condominium Building Association Policy (RCBAP)?

Answer: The RCBAP is a master policy for residential condominiums issued by FEMA. A residential condominium building is defined as having 75 percent or more of the building's floor area in residential use. It may be purchased only by condominium owners associations. The RCBAP covers both the common and individually owned building elements within the units, improvements within the units, and contents owned in common (if contents coverage is purchased). The maximum amount of building coverage that can be purchased under an RCBAP is either 100 percent of the replacement cost value of the building, including amounts to repair or replace the foundation and its supporting structures, or the total number of units in the condominium building times $250,000, whichever is less. RCBAP coverage is available only for residential condominium buildings in Regular Program communities.

28. What is the amount of flood insurance coverage that a lender must require with respect to residential condominium units, including those located in multi-story condominium complexes, to comply with the mandatory purchase requirements under the Act and the Regulation?

Answer: To comply with the Regulation, the lender must ensure that the minimum amount of flood insurance covering the condominium unit is the lesser of:

The outstanding principal balance of the loan(s); or

The maximum amount of insurance available under the NFIP, which is the lesser of:

The maximum limit available for the residential condominium unit; or

The ``insurable value'' allocated to the residential condominium unit, which is the replacement cost value of the condominium building divided by the number of units.

Effective October 1, 2007, FEMA required agents to provide on the declaration page of the RCBAP the replacement cost value of the condominium building and the number of units. Lenders may rely on the replacement cost value and number of units on the RCBAP declaration page in determining insurable value unless they have reason to believe that such amounts clearly conflict with other available information. If there is a conflict, the lender should notify the borrower of the facts that cause the lender to believe there is a conflict. If the lender believes that the borrower is underinsured, it should require the purchase of a Dwelling Policy for supplemental coverage.

Assuming that the outstanding principal balance of the loan is greater than the maximum amount of coverage available under the NFIP, the lender must require a borrower whose loan is secured by a residential condominium unit to either:

Ensure the condominium owners association has purchased an NFIP Residential Condominium Building Association Policy (RCBAP) covering either 100 percent of the insurable value (replacement cost) of the building, including amounts to repair or replace the foundation and its supporting structures, or the total number of units in the condominium building times $250,000, whichever is less; or

Obtain a dwelling policy if there is no RCBAP, as explained in question and answer 29, or if the RCBAP coverage is less than 100 percent of the replacement cost value of the building or the total number of units in the condominium building times $250,000, whichever is less, as explained in question and answer 30.

Example: Lender makes a loan in the principal amount of $300,000 secured by a condominium unit in a 50-unit condominium building, which is located in an SFHA within a participating community, with a replacement cost of $15 million and insured by an RCBAP with $12.5 million of coverage.

Outstanding principal balance of loan is $300,000.

Maximum amount of coverage available under the NFIP, which is the lesser of:

Maximum limit available for the residential condominium unit is $250,000; or

Insurable value of the unit based on 100 percent of the building's replacement cost value ($15 million / 50 = $300,000).

The lender does not need to require additional flood insurance since the RCBAP's $250,000 per unit coverage ($12.5 million / 50 = $250,000) satisfies the Regulation's mandatory flood insurance requirement. (This is the lesser of the outstanding principal balance ($300,000), the maximum coverage available under the NFIP ($250,000), or the insurable value ($300,000)).

The guidance in this question and answer will apply to any loan that is made, increased, extended, or renewed after the effective date of this revised guidance. This revised guidance will not apply to any loans made prior to the effective date of this guidance until a trigger event occurs (that is, the loan is refinanced, extended, increased, or renewed) in connection with the loan. Absent a new trigger event, loans made prior to the effective date of this new guidance will be considered compliant if they complied with the Agencies' previous guidance, which stated that an RCBAP that provided 80 percent RCV coverage was sufficient.

29. What action must a lender take if there is no RCBAP coverage?

Answer: If there is no RCBAP, either because the condominium association will not obtain a policy or because individual unit owners are responsible for obtaining their own insurance, then the lender must require the individual unit owner/borrower to obtain a dwelling policy in an amount sufficient to meet the requirements outlined in Question 28.

A dwelling policy is available for condominium unit owners' purchase when there is no or inadequate RCBAP [[Page 35939]] coverage. When coverage by an RCBAP is inadequate, the dwelling policy may provide individual unit owners with supplemental building coverage to the RCBAP. The RCBAP and the dwelling policy are coordinated such that the dwelling policy purchased by the unit owner responds to shortfalls on building coverage pertaining either to improvements owned by the insured unit owner or to assessments. However, the dwelling policy does not extend the RCBAP limits, nor does it enable the condominium association to fill in gaps in coverage.

Example: The lender makes a loan in the principal amount of $175,000 secured by a condominium unit in a 50-unit condominium building, which is located in an SFHA within a participating community, with a replacement cost value of $10 million; however, there is no RCBAP.

Outstanding principal balance of loan is $175,000.

Maximum amount of coverage available under the NFIP, which is the lesser of:

Maximum limit available for the residential condominium unit is $250,000; or

Insurable value of the unit based on 100 percent of the building's replacement cost value ($10 million / 50 = $200,000).

The lender must require the individual unit owner/borrower to purchase a flood insurance dwelling policy in the amount of at least $175,000, since there is no RCBAP, to satisfy the Regulation's mandatory flood insurance requirement. (This is the lesser of the outstanding principal balance ($175,000), the maximum coverage available under the NFIP ($250,000), or the insurable value ($200,000).)

30. What action must a lender take if the RCBAP coverage is insufficient to meet the Regulation's mandatory purchase requirements for a loan secured by an individual residential condominium unit?

Answer: If the lender determines that flood insurance coverage purchased under the RCBAP is insufficient to meet the Regulation's mandatory purchase requirements, then the lender should request that the individual unit owner/borrower ask the condominium association to obtain additional coverage that would be sufficient to meet the Regulation's requirements (see question and answer 28). If the condominium association does not obtain sufficient coverage, then the lender must require the individual unit owner/borrower to purchase a dwelling policy in an amount sufficient to meet the Regulation's flood insurance requirements. The amount of coverage under the dwelling policy required to be purchased by the individual unit owner would be the difference between the RCBAP's coverage allocated to that unit and the Regulation's mandatory flood insurance requirements (see question and answer 29).

Example: Lender makes a loan in the principal amount of $300,000 secured by a condominium unit in a 50-unit condominium building, which is located in an SFHA within a participating community, with a replacement cost value of $10 million; however, the RCBAP is at 80 percent of replacement cost value ($8 million or $160,000 per unit).

Outstanding principal balance of loan is $300,000.

Maximum amount of coverage available under the NFIP, which is the lesser of:

Maximum limit available for the residential condominium unit is $250,000; or

Insurable value of the unit based on 100 percent of the building's replacement value ($10 million / 50 = $200,000).

The lender must require the individual unit owner/borrower to purchase a flood insurance dwelling policy in the amount of $40,000 to satisfy the Regulation's mandatory flood insurance requirement of $200,000. (This is the lesser of the outstanding principal balance ($300,000), the maximum coverage available under the NFIP ($250,000), or the insurable value ($200,000).) The RCBAP fulfills only $160,000 of the Regulation's flood insurance requirement.

While the individual unit owner's purchase of a separate dwelling policy that provides for adequate flood insurance coverage under the Regulation will satisfy the Regulation's mandatory flood insurance requirements, the lender and the individual unit owner/borrower may still be exposed to additional risk of loss. Lenders are encouraged to apprise borrowers of this risk. The dwelling policy provides individual unit owners with supplemental building coverage to the RCBAP. The policies are coordinated such that the dwelling policy purchased by the unit owner responds to shortfalls on building coverage pertaining either to improvements owned by the insured unit owner or to assessments. However, the dwelling policy does not extend the RCBAP limits, nor does it enable the condominium association to fill in gaps in coverage.

The risk arises because the individual unit owner's dwelling policy may contain claim limitations that prevent the dwelling policy from covering the individual unit owner's share of the co-insurance penalty, which is triggered when the amount of insurance under the RCBAP is less than 80 percent of the building's replacement cost value at the time of loss. In addition, following a major flood loss, the insured unit owner may have to rely upon the condominium association's and other unit owners' financial ability to make the necessary repairs to common elements in the building, such as electricity, heating, plumbing, and elevators. It is incumbent on the lender to understand these limitations.

31. What must a lender do when a loan secured by a residential condominium unit is in a complex whose condominium association allows its existing RCBAP to lapse?

Answer: If a lender determines at any time during the term of a designated loan that the loan is not covered by flood insurance or is covered by such insurance in an amount less than that required under the Act and the Regulation, the lender must notify the individual unit owner/borrower of the requirement to maintain flood insurance coverage sufficient to meet the Regulation's mandatory requirements. The lender should encourage the individual unit owner/borrower to work with the condominium association to acquire a new RCBAP in an amount sufficient to meet the Regulation's mandatory flood insurance requirement (see question and answer 28). Failing that, the lender must require the individual unit owner/borrower to obtain a flood insurance dwelling policy in an amount sufficient to meet the Regulation's mandatory flood insurance requirement (see questions and answers 29 and 30). If the borrower/unit owner or the condominium association fails to purchase flood insurance sufficient to meet the Regulation's mandatory requirements within 45 days of the lender's notification to the individual unit owner/borrower of inadequate insurance coverage, the lender must force place the necessary flood insurance.

32. How does the RCBAP's co-insurance penalty apply in the case of residential condominiums, including those located in multi-story condominium complexes?

Answer: In the event the RCBAP's coverage on a condominium building at the time of loss is less than 80 percent of either the building's replacement cost or the maximum amount of insurance available for that building under the NFIP (whichever is less), then the loss payment, which is subject to a co-insurance penalty, is determined as follows (subject to all other relevant conditions in this policy, including those pertaining to valuation, adjustment, settlement, and payment of loss):

A. Divide the actual amount of flood insurance carried on the condominium building at the time of loss by 80 percent of either its replacement cost or the maximum amount of insurance
[[Page 35940]] available for the building under the NFIP, whichever is less.

B. Multiply the amount of loss, before application of the deductible, by the figure determined in A above.

C. Subtract the deductible from the figure determined in B above.

The policy will pay the amount determined in C above, or the amount of insurance carried, whichever is less.

Example 1: (Inadequate insurance amount to avoid penalty).

Replacement value of the building: $250,000.

80% of replacement value of the building: $200,000.

Actual amount of insurance carried: $180,000.

Amount of the loss: $150,000.

Deductible: $ 500.

Step A: 180,000 / 200,000 = .90 (90% of what should be carried to avoid co-insurance penalty)

Step B: 150,000 x .90 = 135,000

Step C: 135,000 - 500 = 134,500

The policy will pay no more than $134,500. The remaining $15,500 is not covered due to the co-insurance penalty ($15,000) and application of the deductible ($500). Unit owners' dwelling policies will not cover any assessment that may be imposed to cover the costs of repair that are not covered by the RCBAP.

Example 2: (Adequate insurance amount to avoid penalty).

Replacement value of the building: $250,000.

80% of replacement value of the building: $200,000.

Actual amount of insurance carried: $200,000.

Amount of the loss: $150,000.

Deductible: $ 500.

Step A: 200,000 / 200,000 = 1.00 (100% of what should be carried to avoid co-insurance penalty)

Step B: 150,000 x 1.00 = 150,000

Step C: 150,000 - 500 = 149,500

In this example there is no co-insurance penalty, because the actual amount of insurance carried meets the 80 percent requirement to avoid the co-insurance penalty. The policy will pay no more than $149,500 ($150,000 amount of loss minus the $500 deductible). This example also assumes a $150,000 outstanding principal loan balance.

33. What are the major factors involved with the individual unit owner's dwelling policy's coverage limitations with respect to the condominium association's RCBAP coverage?

Answer: The following examples demonstrate how the unit owner's dwelling policy may cover in certain loss situations:

Example 1: (RCBAP insured to at least 80 percent of building replacement cost).

If the unit owner purchases building coverage under the dwelling policy and if there is an RCBAP covering at least 80 percent of the building replacement cost value, the loss assessment coverage under the dwelling policy will pay that part of a loss that exceeds 80 percent of the association's building replacement cost allocated to that unit.

The loss assessment coverage under the dwelling policy will not cover the association's policy deductible purchased by the condominium association.

If building elements within units have also been damaged, the dwelling policy pays to repair building elements after the RCBAP limits that apply to the unit have been exhausted. Coverage combinations cannot exceed the total limit of $250,000 per unit.

Example 2: (RCBAP insured to less than 80 percent of building replacement cost).

If the unit owner purchases building coverage under the dwelling policy and there is an RCBAP that was insured to less than 80 percent of the building replacement cost value at the time of loss, the loss assessment coverage cannot be used to reimburse the association for its co-insurance penalty.

Loss assessment is available only to cover the building damages in excess of the 80-percent required amount at the time of loss. Thus, the covered damages to the condominium association building must be greater than 80 percent of the building replacement cost value at the time of loss before the loss assessment coverage under the dwelling policy becomes available. Under the dwelling policy, covered repairs to the unit, if applicable, would have priority in payment over loss assessments against the unit owner.

Example 3: (No RCBAP),

If the unit owner purchases building coverage under the dwelling policy and there is no RCBAP, the dwelling policy covers assessments against unit owners for damages to common areas up to the dwelling policy limit.

However, if there is damage to the building elements of the unit as well, the combined payment of unit building damages, which would apply first, and the loss assessment may not exceed the building coverage limit under the dwelling policy.

VII. Flood Insurance Requirements for Home Equity Loans, Lines of Credit, Subordinate Liens, and Other Security Interests in Collateral Located in an SFHA

34. Is a home equity loan considered a designated loan that requires flood insurance?

Answer: Yes. A home equity loan is a designated loan, regardless of the lien priority, if the loan is secured by a building or a mobile home located in an SFHA in which flood insurance is available under the Act.

35. Does a draw against an approved line of credit secured by a building or mobile home, which is located in an SFHA in which flood insurance is available under the Act, require a flood determination under the Regulation?

Answer: No. While a line of credit secured by a building or mobile home located in an SFHA in which flood insurance is available under the Act is a designated loan and, therefore, requires a flood determination before the loan is made, draws against an approved line do not require further determinations. However, a request made for an increase in an approved line of credit may require a new determination, depending upon whether a previous determination was done. (See response to question 68 in Section XIII. Required use of Standard Flood Hazard Determination Form.)

36. When a lender makes, increases, extends or renews a second mortgage secured by a building or mobile home located in an SFHA, how much flood insurance must the lender require?

Answer: The lender must ensure that adequate flood insurance is in place or require that additional flood insurance coverage be added to the flood insurance policy in the amount of the lesser of either the combined total outstanding principal balance of the first and second loan, the maximum amount available under the Act (currently $250,000 for a residential building and $500,000 for a nonresidential building), or the insurable value of the building or mobile home. The junior lienholder should also ensure that the borrower adds the junior lienholder's name as mortgagee/loss payee to the existing flood insurance policy. Given the provisions of NFIP policies, a lender cannot comply with the Act and Regulation by requiring the purchase of an NFIP flood insurance policy only in the amount of the outstanding principal balance of the second mortgage without regard to the amount of flood insurance coverage on a first mortgage.

A junior lienholder should work with the senior lienholder, the borrower, or with both of these parties, to determine how much flood insurance is needed to cover improved real estate collateral. A junior lienholder should obtain the borrower's consent in the loan agreement or otherwise for the junior lienholder to obtain information on balance and existing flood insurance coverage on senior lien loans from the senior lienholder.

Junior lienholders also have the option of pulling a borrower's credit report and using the information from that document to establish how much flood insurance is necessary upon increasing, extending or renewing a junior lien, thus protecting the interests of the junior lienholder, the senior lienholders, and the borrower. In the limited situation where a junior lienholder or its servicer is unable to [[Page 35941]] obtain the necessary information about the amount of flood insurance in place on the outstanding balance of a senior lien (for example, in the context of a loan renewal), the lender may presume that the amount of insurance coverage relating to the senior lien in place at the time the junior lien was first established (provided that the amount of flood insurance relating to the senior lien was adequate at the time) continues to be sufficient.

Example 1: Lender A makes a first mortgage with a principal balance of $100,000, but improperly requires only $75,000 of flood insurance coverage, which the borrower satisfied by obtaining an NFIP policy. Lender B issues a second mortgage with a principal balance of $50,000. The insurable value of the residential building securing the loans is $200,000. Lender B must ensure that flood insurance in the amount of $150,000 is purchased and maintained. If Lender B were to require additional flood insurance only in an amount equal to the principal balance of the second mortgage ($50,000), its interest in the secured property would not be fully protected in the event of a flood loss because Lender A would have prior claim on $100,000 of the loss payment towards its principal balance of $100,000, while Lender B would receive only $25,000 of the loss payment toward its principal balance of $50,000.

Example 2: Lender A, who is not directly covered by the Act or Regulation, makes a first mortgage with a principal balance of $100,000 and does not require flood insurance. Lender B, who is directly covered by the Act and Regulation, issues a second mortgage with a principal balance of $50,000. The insurable value of the residential building securing the loans is $200,000. Lender B must ensure that flood insurance in the amount of $150,000 is purchased and maintained. If Lender B were to require flood insurance only in an amount equal to the principal balance of the second mortgage ($50,000) through an NFIP policy, then its interest in the secured property would not be protected in the event of a flood loss because Lender A would have prior claim on the entire $50,000 loss payment towards its principal balance of $100,000.

Example 3: Lender A made a first mortgage with a principal balance of $100,000 on improved real estate with a fair market value of $150,000. The insurable value of the residential building on the improved real estate is $90,000; however, Lender A improperly required only $70,000 of flood insurance coverage, which the borrower satisfied by purchasing an NFIP policy. Lender B later takes a second mortgage on the property with a principal balance of $10,000. Lender B must ensure that flood insurance in the amount of $90,000 (the insurable value) is purchased and maintained on the secured property to comply with the Act and Regulation. If Lender B were to require flood insurance only in an amount equal to the principal balance of the second mortgage ($10,000), its interest in the secured property would not be protected in the event of a flood loss because Lender A would have prior claim on the entire $70,000 loss payment towards the insurable value of $90,000.

37. If a borrower requesting a loan secured by a junior lien provides evidence that flood insurance coverage is in place, does the lender have to make a new determination? Does the lender have to adjust

the insurance coverage?

Answer: It depends. Assuming the requirements in Section 528 of the Act (42 U.S.C. 4104b) are met and the same lender made the first mortgage, then a new determination may not be necessary, when the existing determination is not more than seven years old, there have been no map changes, and the determination was recorded on an SFHDF. If, however, a lender other than the one that made the first mortgage loan is making the junior lien loan, a new determination would be required because this lender would be deemed to be ``making'' a new loan. In either situation, the lender will need to determine whether the amount of insurance in force is sufficient to cover the lesser of the combined outstanding principal balance of all loans (including the junior lien loan), the insurable value, or the maximum amount of coverage available on the improved real estate. This will hold true whether the subordinate lien loan is a home equity loan or some other type of junior lien loan.

38. If the loan request is to finance inventory stored in a building located within an SFHA, but the building is not security for the loan, is flood insurance required?

Answer: No. The Act and the Regulation provide that a lender shall not make, increase, extend, or renew a designated loan, that is a loan secured by a building or mobile home located or to be located in an SFHA, ``unless the building or mobile home and any personal property securing such loan'' is covered by flood insurance for the term of the loan. In this example, the collateral is not the type that could secure a designated loan because it does not include a building or mobile home; rather, the collateral is the inventory alone.

39. Is flood insurance required if a building and its contents both secure a loan, and the building is located in an SFHA in which flood insurance is available?

Answer: Yes. Flood insurance is required for the building located in the SFHA and any contents stored in that building.

Example: Lender A makes a loan for $200,000 that is secured by a warehouse with an insurable value of $150,000 and inventory in the warehouse worth $100,000. The Act and Regulation require that flood insurance coverage be obtained for the lesser of the outstanding principal balance of the loan or the maximum amount of flood insurance that is available under the NFIP. The maximum amount of insurance that is available for both building and contents is $500,000 for each category. In this situation, Federal flood insurance requirements could be satisfied by placing $150,000 worth of flood insurance coverage on the warehouse, thus insuring it to its insurable value, and $50,000 worth of contents flood insurance coverage on the inventory, thus providing total coverage in the amount of the outstanding principal balance of the loan. Note that this holds true even though the inventory is worth $200,000.

40. If a loan is secured by Building A, which is located in an SFHA, and contents, which are located in Building B, is flood insurance required on the contents securing a loan?

Answer: No. If collateral securing the loan is stored in Building B, which does not secure the loan, then flood insurance is not required on those contents whether or not Building B is located in an SFHA.

41. Does the Regulation apply where the lender takes a security interest in a building or mobile home located in an SFHA only as an ``abundance of caution''?

Answer: Yes. The Act and Regulation look to the collateral securing the loan. If the lender takes a security interest in improved real estate located in an SFHA, then flood insurance is required.

42. If a borrower offers a note on a single-family dwelling as collateral for a loan but the lender does not take a security interest in the dwelling itself, is this a designated loan that requires flood insurance?

Answer: No. A designated loan is a loan secured by a building or mobile home. In this example, the lender did not take a security interest in the building; therefore, the loan is not a designated loan.

43. If a lender makes a loan that is not secured by real estate, but is made on the condition of a personal guarantee by a third party who gives the lender a security interest in improved real estate owned by the third party that is located in an SFHA in which flood insurance is available, is it a designated loan that requires flood insurance?

Answer: Yes. The making of a loan on condition of a personal guarantee by a third party and further secured by improved real estate, which is located in [[Page 35942]] an SFHA, owned by that third party is so closely tied to the making of the loan that it is considered a designated loan that requires flood insurance.

VIII. Flood Insurance Requirements in the Event of the Sale or Transfer of a Designated Loan and/or Its Servicing Rights

44. How do the flood insurance requirements under the Regulation apply to regulated lenders under the following scenarios involving loan servicing?

Scenario 1: A regulated lender originates a designated loan secured by a building or mobile home located in an SFHA in which flood insurance is available under the Act. The regulated lender makes the initial flood determination, provides the borrower with appropriate notice, and flood insurance is obtained. The regulated lender initially services the loan; however, the regulated lender subsequently sells both the loan and the servicing rights to a nonregulated party. What are the regulated lender's requirements under the Regulation? What are the regulated lender's requirements under the Regulation if it only transfers or sells the servicing rights, but retains ownership of the loan?

Answer: The regulated lender must comply with all requirements of the Regulation, including making the initial flood determination, providing appropriate notice to the borrower, and ensuring that the proper amount of insurance is obtained. In the event the regulated lender sells or transfers the loan and servicing rights, the regulated lender must provide notice of the identity of the new servicer to FEMA or its designee. Once the regulated lender has sold the loan and the servicing rights, the lender has no further obligation regarding flood insurance on the loan.

If the regulated lender retains ownership of the loan and only transfers or sells the servicing rights to a nonregulated party, the regulated lender must notify FEMA or its designee of the identity of the new servicer. The servicing contract should require the servicer to comply with all the requirements that are imposed on the regulated lender as owner of the loan, including escrow of insurance premiums and force placement of insurance, if necessary.

Generally, the Regulation does not impose obligations on a loan servicer independent from the obligations it imposes on the owner of a loan. Loan servicers are covered by the escrow, force placement, and flood hazard determination fee provisions of the Act and Regulation primarily so that they may perform the administrative tasks for the regulated lender, without fear of liability to the borrower for the imposition of unauthorized charges. It is the Agencies' longstanding position, as described in the preamble to the Regulation that the obligation of a loan servicer to fulfill administrative duties with respect to the flood insurance requirements arises from the contractual relationship between the loan servicer and the regulated lender or from other commonly accepted standards for performance of servicing obligations. The regulated lender remains ultimately liable for fulfillment of those responsibilities, and must take adequate steps to ensure that the loan servicer will maintain compliance with the flood insurance requirements.

Scenario 2: A nonregulated lender originates a designated loan, secured by a building or mobile home located in an SFHA in which flood insurance is available under the Act. The nonregulated lender does not make an initial flood determination or notify the borrower of the need to obtain insurance. The nonregulated lender sells the loan and servicing rights to a regulated lender. What are the regulated lender's requirements under the Regulation? What are the regulated lender's requirements if it only purchases the servicing rights?

Answer: A regulated lender's purchase of a loan and servicing rights, secured by a building or mobile home located in an SFHA in which flood insurance is available under the Act, is not an event that triggers any requirements under the Regulation, such as making a new flood determination or requiring a borrower to purchase flood insurance. The Regulation's requirements are triggered when a regulated lender makes, increases, extends, or renews a designated loan. A regulated lender's purchase of a loan does not fall within any of those categories. However, if a regulated lender becomes aware at any point during the life of a designated loan that flood insurance is required, then the regulated lender must comply with the Regulation, including force placing insurance, if necessary. Depending upon the circumstances, safety and soundness considerations may sometimes necessitate that the lender undertake sufficient due diligence upon purchase of a loan as to put the lender on notice of lack of adequate flood insurance. If the purchasing lender subsequently extends, increases, or renews a designated loan, it must also comply with the
Act and Regulation.

Where a regulated lender purchases only the servicing rights to a loan originated by a nonregulated lender, the regulated lender is obligated only to follow the terms of its servicing contract with the owner of the loan. In the event the regulated lender subsequently sells or transfers the servicing rights on that loan, the regulated lender must notify FEMA or its designee of the identity of the new servicer, if required to do so by the servicing contract with the owner of the loan.

45. When a regulated lender makes a designated loan and will be servicing that loan, what are the requirements for notifying the Director of FEMA or the Director's designee?

Answer: FEMA stated in a June 4, 1996, letter that the Director's designee is the insurance company issuing the flood insurance policy. The borrower's purchase of a policy (or the regulated lender's force placement of a policy) will constitute notice to FEMA when the regulated lender is servicing that loan.

In the event the servicing is subsequently transferred to a new servicer, the regulated lender must provide notice to the insurance company of the identity of the new servicer no later than 60 days after the effective date of such a change.

46. Would a RESPA Notice of Transfer sent to the Director of FEMA (or the Director's designee) satisfy the regulatory provisions of the Act?

Answer: Yes. The delivery of a copy of the Notice of Transfer or any other form of notice is sufficient if the sender includes, on or with the notice, the following information that FEMA has indicated is needed by its designee:

Borrower's full name;

Flood insurance policy number;

Property address (including city and State);

Name of lender or servicer making notification;

Name and address of new servicer; and

Name and telephone number of contact person at new servicer.

47. Can delivery of the notice be made electronically, including batch transmissions?

Answer: Yes. The Regulation specifically permits transmission by electronic means. A timely batch transmission of the notice would also be permissible, if it is acceptable to the Director's designee.

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48. If the loan and its servicing rights are sold by the regulated lender, is the regulated lender required to provide notice to the Director or the Director's designee?

Answer: Yes. Failure to provide such notice would defeat the purpose of the notice requirement because FEMA would have no record of the identity of either the owner or servicer of the loan.

49. Is a regulated lender required to provide notice when the servicer, not the regulated lender, sells or transfers the servicing rights to another servicer?

Answer: No. After servicing rights are sold or transferred, subsequent notification obligations are the responsibility of the new servicer. The obligation of the regulated lender to notify the Director or the Director's designee of the identity of the servicer transfers to the new servicer. The duty to notify the Director or the Director's designee of any subsequent sale or transfer of the servicing rights and responsibilities belongs to that servicer. For example, a financial institution makes and services the loan. It then sells the loan in the secondary market and also sells the servicing rights to a mortgage company. The financial institution notifies the Director's designee of the identity of the new servicer and the other information requested by FEMA so that flood insurance transactions can be properly administered by the Director's designee. If the mortgage company later sells the servicing rights to another firm, the mortgage company, not the financial institution, is responsible for notifying the Director's designee of the identity of the new servicer.

50. In the event of a merger or acquisition of one lending institution with another, what are the responsibilities of the parties for notifying the Director's designee?

Answer: If an institution is acquired by or merges with another institution, the duty to provide notice for the loans being serviced by the acquired institution will fall to the successor institution in the event that notification is not provided by the acquired institution prior to the effective date of the acquisition or merger.

IX. Escrow Requirements

51. Are multi-family buildings or mixed-use properties included in the definition of ``residential improved real estate'' under the Regulation for which escrows are required?

Answer: ``Residential improved real estate'' is defined under the Regulation as ``real estate upon which a home or other residential building is located or to be located.'' A loan secured by residential improved real estate located or to be located in an SFHA in which flood insurance is available is a designated loan. Lenders are required to escrow flood insurance premiums and fees for mandatory flood insurance for such loans if the lender requires the escrow of taxes, hazard insurance premiums or any other charges for loans secured by residential improved real estate. A lender is not required to escrow flood insurance premiums and fees for a particular loan if it does not require escrowing of any other charges for that loan.

Multi-family buildings. For the purposes of the Act and the Regulation, the definition of residential improved real estate does not make a distinction between whether a building is single- or multi-family, or whether a building is owner- or renter-occupied. Single-family dwellings (including mobile homes), two-to-four family dwellings, and multi-family properties containing five or more residential units are covered under the Act's escrow provisions. If the building securing the loan meets the Regulation's definition of residential improved real estate and the lender requires the escrow of any other charges such as taxes or hazard insurance premiums, then the lender is required to also escrow premiums and fees for flood insurance.

Mixed-use properties. The lender should look to the primary use of a building to determine whether it meets the definition of ``residential improved real estate.'' (See questions and answers 11 and 12 for guidance on residential and nonresidential buildings.) If the primary use of a mixed-use property is for residential purposes, the Regulation's escrow requirements apply.

52. When must escrow accounts be established for flood insurance purposes?

Answer: If a lender requires the escrow of taxes, insurance premiums, fees, or any other charges for a loan secured by residential improved real estate or a mobile home, the lender must also require the escrow of all flood insurance premiums and fees. When administering loans secured by one-to-four family dwellings, lenders should look to the definition of ``Federally related mortgage loan'' contained in the Real Estate Settlement Procedures Act (RESPA) to see whether a particular loan is subject to the escrow requirements in Section 10 of RESPA. (This includes individual units of condominiums. Individual units of cooperatives, although covered by Section 10 of RESPA, are not insurable under the NFIP and are not covered by the Regulation.) Loans on multi-family dwellings with five or more units are not covered by RESPA requirements. Pursuant to the Regulation, however, lenders must escrow premiums and fees for any required flood insurance if the lender requires escrows for other purposes, such as hazard insurance or taxes.

53. Do voluntary escrow accounts established at the request of the borrower trigger a requirement for the lender to escrow premiums for required flood insurance?

Answer: No. If escrow accounts for other purposes are established at the voluntary request of the borrower, the lender is not required to establish escrow accounts for flood insurance premiums. Examiners should review the loan policies of the lender and the underlying legal obligation between the parties to the loan to determine whether the accounts are, in fact, voluntary. For example, when a lender's loan policies require borrowers to establish escrow accounts for other purposes and the contractual obligation permits the lender to establish escrow accounts for those other purposes, the lender will have the burden of demonstrating that an existing escrow was made pursuant to a voluntary request by the borrower.

54. Will premiums paid for credit life insurance, disability insurance, or similar insurance programs be viewed as escrow accounts requiring the escrow of flood insurance premiums?

Answer: No. Premiums paid for these types of insurance policies will not trigger the escrow requirement for flood insurance premiums.

55. Will escrow-type accounts for commercial loans, secured by multi-family residential buildings, trigger the escrow requirement for flood insurance premiums?

Answer: It depends. Escrow-type accounts established in connection with the underlying agreement between the buyer and seller, or that relate to the commercial venture itself, such as ``interest reserve accounts,'' ``compensating balance accounts,'' ``marketing accounts,'' and similar accounts are not the type of accounts that constitute escrow accounts for the purpose of the Regulation. However, escrow accounts established for the protection of the property, such as escrows for hazard insurance premiums or local real estate taxes, are the types of escrow accounts that trigger the [[Page 35944]] requirement to escrow flood insurance premiums.

56. Which requirements for escrow accounts apply to properties adequately covered by RCBAPs?

Answer: RCBAPs (Residential Condominium Building Association Policies) are policies purchased by the condominium association on behalf of itself and the individual unit owners in the condominium. A portion of the periodic dues paid to the association by the condominium owners applies to the premiums on the policy. When a lender makes, increases, renews, or extends a loan secured by a condominium unit that is adequately covered by an RCBAP and dues to the condominium association apply to the RCBAP premiums, an escrow account is not required. However, if the RCBAP coverage is inadequate and the unit is also covered by a dwelling form policy, premiums for the dwelling form policy would need to be escrowed if the lender requires escrow for
other purposes, such as hazard insurance or taxes. Lenders should exercise due diligence with respect to continuing compliance with the insurance requirements on the part of the condominium association.

X. Force Placement of Flood Insurance

57. What is the requirement for the force placement of flood insurance under the Act and Regulation?

Answer: The Act and Regulation require a lender to force place flood insurance, if all of the following circumstances occur:

The lender determines at any time during the life of the loan that the property securing the loan is located in an SFHA;

Flood insurance under the Act is available for improved property securing the loan;

The lender determines that flood insurance coverage is inadequate or does not exist; and

After required notice, the borrower fails to purchase the appropriate amount of coverage.

The Act and Regulation require the lender, or its servicer, to send notice to the borrower upon making a determination that the improved real estate collateral's insurance coverage has expired or is less than the amount required for that particular property, such as upon receipt of the notice of cancellation or expiration from the insurance provider. The notice to the borrower must also state that if the borrower does not obtain the insurance within the 45-day period, the lender will purchase the insurance on behalf of the borrower and may charge the borrower for the cost of premiums and fees to obtain the coverage. The Act does not permit a lender or its servicer to send the required 45-day notice to the borrower prior to making a determination that flood insurance coverage is inadequate. If adequate insurance is not obtained by the borrower within the 45-day notice period, then the lender must purchase insurance on the borrower's behalf. Standard Fannie Mae/Freddie Mac documents permit the servicer or lender to add those charges to the principal amount of the loan.

FEMA developed the Mortgage Portfolio Protection Program (MPPP) to assist lenders in connection with force placement procedures. FEMA published these procedures in the Federal Register on August 29, 1995 (60 FR 44881). Appendix A of FEMA's September 2007 Mandatory Purchase of Flood Insurance Guidelines sets out the MPPP Guidelines and Requirements, including force placement procedures and examples of notification letters to be used in connection with the MPPP.

58. Can a servicer force place on behalf of a lender?

Answer: Yes. Assuming the statutory prerequisites for force placement are met, and subject to the servicing contract between the lender and the servicer, the Act clearly authorizes servicers to force place flood insurance on behalf of the lender, following the procedures set forth in the Regulation.

59. When force placement occurs, what is the amount of insurance required to be placed?

Answer: The amount of flood insurance coverage required is the same regardless of how the insurance is placed. (See Section II. Determining the appropriate amount of flood insurance required under the Act and Regulation and also Section VII. Flood Insurance Requirements for Home Equity Loans, Lines of Credit, Subordinate Liens, and Other Security Interests in Collateral Located in an SFHA.)

60. Can the 45-day notice period be accelerated by sending notice to the borrower prior to the actual date of expiration of flood insurance coverage?

Answer: [Reserved]

61. Is a reasonable period of time allowed after the end of the 45-day notice period for a lender or its servicer to implement force placement?

Answer: [Reserved]

62. Does a lender or its servicer have the authority to charge a borrower for the cost of insurance coverage during the 45-day notice period?

Answer: [Reserved]

XI. Private Insurance Policies

63. May a lender rely on a private insurance policy to meet its obligation to ensure that its designated loans are covered by an adequate amount of flood insurance?

Answer: It depends. A private insurance policy may be an adequate substitute for NFIP insurance if it meets the criteria set forth by FEMA in its Mandatory Purchase of Flood Insurance Guidelines. Similarly, a private insurance policy may be used to supplement NFIP insurance for designated loans where the property is underinsured if it meets the criteria set forth by FEMA in its Mandatory Purchase of Flood Insurance Guidelines. FEMA states that, to the extent that a private policy differs from the NFIP Standard Flood Insurance Policy, the differences should be carefully examined before the policy is accepted as sufficient protection under the law. FEMA also states that the suitability of private policies need only be considered when the mandatory purchase requirement applies.

64. When may a lender rely on a private insurance policy that does not meet the criteria set forth by FEMA?

Answer: A lender may rely on a private insurance policy that does not meet the criteria set forth by FEMA only in limited circumstances. For example, when a flood insurance policy has expired and the borrower has failed to renew coverage, private insurance policies that do not meet the criteria set forth by FEMA, such as private insurance policies providing portfolio-wide blanket coverage, may be useful protection for the lender for a gap in coverage in the period of time before a force placed policy takes effect. However, the lender must still force place adequate coverage in a timely manner, as required, and may not rely on a private insurance policy that does not meet the criteria set forth by FEMA on an ongoing basis.

XII. Required Use of Standard Flood Hazard Determination Form (SFHDF)

65. Does the SFHDF replace the borrower notification form?

Answer: No. The SFHDF is used by the lender to determine whether the building or mobile home offered as collateral security for a loan is or will be located in an SFHA in which flood [[Page 35945]] insurance is available under the Act. The notification form, on the other hand, is used to notify the borrower(s) that the building or mobile home is or will be located in an SFHA and to inform them about flood insurance requirements and the availability of Federal disaster relief assistance.

66. May a lender provide the SFHDF to the borrower?

Answer: Yes. While not a statutory requirement, a lender may provide a copy of the flood determination to the borrower so the borrower can provide it to the insurance agent in order to minimize flood zone discrepancies between the lender's determination and the borrower's policy. A lender would also need to make the determination available to the borrower in case of a special flood hazard determination review, which must be requested jointly by the lender and the borrower. In the event a lender provides the SFHDF to the borrower, the signature of the borrower is not required to acknowledge receipt of the form.

67. May the SFHDF be used in electronic format?

Answer: Yes. In the final rule adopting the SFHDF, FEMA stated: ``If an electronic format is used, the format and exact layout of the Standard Flood Hazard Determination Form is not required, but the fields and elements listed on the form are required. Any electronic format used by lenders must contain all mandatory fields indicated on the form.'' It should be noted, however, that the lender must be able to reproduce the form upon receiving a document request by its Federal supervisory agency.

68. May a lender rely on a previous determination for a refinancing or assumption of a loan or multiple

loans to the same borrower secured by the same property?

Answer: It depends. Section 528 of the Act, 42 U.S.C. 4104b(e), permits a lender to rely on a previous flood determination using the SFHDF when it is increasing, extending, renewing, or purchasing a loan secured by a building or a mobile home. Under the Act, the ``making'' of a loan is not listed as a permissible event that permits a lender to rely on a previous determination. When the loan involves a refinancing or assumption by the same lender who obtained the original flood determination on the same property, the lender may rely on the previous determination only if the original determination was made not more than seven years before the date of the transaction, the basis for the determination was set forth on the SFHDF, and there were no map revisions or updates affecting the security property since the original determination was made. A loan refinancing or assumption made by a lender different from the one who obtained the original determination
constitutes a new loan, thereby requiring a new determination. Further, if the same lender makes multiple loans to the same borrower secured by the same improved real estate, the lender may rely on its previous determination if the original determination was made not more than seven years before the date of the transaction, the basis for the determination was set forth on the SFHDF, and there were no map revisions or updates affecting the security property since the original determination was made.

XIII. Flood Determination Fees

69. When can lenders or servicers charge the borrower a fee for making a determination?

Answer: There are four instances under the Act and Regulation when the borrower can be charged a specific fee for a flood determination:

When the determination is made in connection with the making, increasing, extending, or renewing of a loan that is initiated by the borrower;

When the determination is prompted by a revision or updating by FEMA of floodplain areas or flood-risk zones;

When the determination is prompted by FEMA's publication of notices or compendia that affect the area in which the security property is located; or

When the determination results in force placement of insurance.

Loan or other contractual documents between the parties may also permit the imposition of fees.

70. May charges made for life-of-loan reviews by flood determination firms be passed along to the borrower?

Answer: Yes. In addition to the initial determination at the time a loan is made, increased, renewed, or extended, many flood determination firms provide a service to the lender to review and report changes in the flood status of a dwelling for the entire term of the loan. The fee charged for the service at loan closing is a composite one for conducting both the original and subsequent reviews. Charging a fee for the original determination is clearly within the permissible purpose envisioned by the Act. The Agencies agree that a determination fee may include, among other things, reasonable fees for a lender, servicer, or third party to monitor the flood hazard status of property securing a loan in order to make determinations on an ongoing basis.

However, the life-of-loan fee is based on the authority to charge a determination fee and, therefore, the monitoring fee may be charged only if the events specified in the answer to Question 69 occur. Further, a lender may not charge a composite determination and life-of-loan fee if the loan does not close, because the life-of-loan fee would be an unearned fee in violation of the Real Estate Settlement Procedures Act.

XIV. Flood Zone Discrepancies

71. What should a lender do when there is a discrepancy between the flood hazard zone designation on the flood determination form and the flood insurance policy?

A lender should only be concerned about a discrepancy on the Standard Flood Hazard Determination Form (the SFHDF) and the one on the flood insurance policy if the discrepancy is between a high-risk zone (A or V) and a low- or moderate-risk zone (B, C, D, or X). In other words, a lender need not be concerned about subcategory differences between flood zones on these two documents. Once in possession of a copy of the flood insurance policy, a lender should systematically compare the flood zone designation on the policy with the zone shown on the SFHDF. If the flood insurance policy shows a lower risk zone than the SFHDF, then lender should investigate. As noted in FEMA's Mandatory Purchase of Flood Insurance Guidelines, Federal law sets the ultimate responsibility to place flood insurance on the lender, with limited reliance permitted on third parties to the extent that the information that those third parties provide is guaranteed.

A lender should first determine whether the difference results from the application of the NFIP's ``Grandfather Rule.'' This rule provides for the continued use of a rating on an insured property when the initial flood insurance policy was issued prior to changes in the hazard rating for the particular flood zone where the property is located. The Grandfather Rule allows policyholders who have maintained continuous coverage and/or who have built in compliance with the Flood Insurance Rate Map to continue to benefit from the prior, more favorable [[Page 35946]] rating for particular pieces of improved property. A discrepancy resulting from application of the NFIP's Grandfather Rule is reasonable and acceptable, but the lender should substantiate these findings.

A lender should also determine whether a difference in flood zone designations is the result of a mistake. To do so, a lender should facilitate communication between itself or the third-party service provider that performed the flood hazard determination for the lender. If it appears that the discrepancy is the result of a mistake, a lender should recheck its determination. If there still appears to be a discrepancy after this step has been taken, a lender and borrower may jointly request that FEMA review the determination to confirm or review the accuracy of the original determination performed by a lender or on the lender's behalf. However, FEMA will only conduct this review if the request is submitted within 45 days of the date the lender notified the
borrower that a building or manufactured home is in an SFHA and flood insurance is required.

If, despite these efforts, the discrepancy is not resolved, or in the course of attempting to resolve a discrepancy, a borrower or an insurance company or its agent is uncooperative in assisting a lender in this attempt, the lender should notify the insurance agent about the insurer's duty pursuant to FEMA's letter of April 16, 2008 (W-08021), to write a flood insurance policy that covers the most hazardous flood zone. When providing this notification, the lender should include its zone information and it should also notify the insurance company itself. The lender should substantiate these communications in its loan file.

72. Can a lender be found in violation of the requirements of the Regulation if, despite the lender's diligence in making the flood hazard determination, notifying the borrower of the risk of flood and the need to obtain flood insurance, and requiring mandatory flood insurance, there is a discrepancy

between the flood hazard zone designation on the flood determination form and the flood insurance policy?

Answer: As noted in question and answer 71 above, lenders should have a process in place to identify and resolve flood zone discrepancies. A lender is in the best position to coordinate between the various parties involved in a mortgage loan transaction to resolve any flood zone discrepancy. If a lender is able to substantiate in its loan file a bona fide effort to resolve a discrepancy, either by finding a legitimate reason for such discrepancy or by attempting to resolve the discrepancy, for example, by contacting FEMA to review the determination, no violation will be cited. If a pattern or practice of unresolved discrepancies is found in a lender's loan portfolio due to a lack of effort on the lender's part to resolve such discrepancies, the Agencies may cite the lender for a violation of the mandatory purchase requirements.

XV. Notice of Special Flood Hazards and Availability of Federal Disaster Relief

73. Does the notice have to be provided to each borrower for a real estate related loan?

Answer: No. In a transaction involving multiple borrowers, the lender need only provide the notice to any one of the borrowers in the transaction. Lenders may provide multiple notices if they choose. The lender and borrower(s) typically designate the borrower to whom the notice will be provided. The notice must be provided to a borrower when the lender determines that the property securing the loan is or will be located in an SFHA.

74. Lenders making loans on mobile homes may not always know where the home is to be located until just prior to, or sometimes after, the time of loan closing. How is the notice requirement applied in these situations?

Answer: When it is not reasonably feasible to give notice before the completion of the transaction, the notice requirement can be met by lenders in mobile home loan transactions if notice is provided to the borrower as soon as practicable after determination that the mobile home will be located in an SFHA. Whenever time constraints can be anticipated, regulated lenders should use their best efforts to provide adequate notice of flood hazards to borrowers at the earliest possible time. In the case of loan transactions secured by mobile homes not located on a permanent foundation, the Agencies note that such ``home only'' transactions are excluded from the definition of mobile home and the notice requirements would not apply to these transactions.

However, as indicated in the preamble to the Regulation, the Agencies encourage a lender to advise the borrower that if the mobile home is later located on a permanent foundation in an SFHA, flood insurance will be required. If the lender, when notified of the location of the mobile home subsequent to the loan closing, determines that it has been placed on a permanent foundation and is located in an SFHA in which flood insurance is available under the Act, flood insurance coverage becomes mandatory and appropriate notice must be given to the borrower under those provisions. If the borrower fails to purchase flood insurance coverage within 45 days after notification, the lender must force place the insurance.

75. When is the lender required to provide notice to the servicer of a loan that flood insurance is required?

Answer: Because the servicer of a loan is often not identified prior to the closing of a loan, the Regulation requires that notice be provided no later than the time the lender transmits other loan data, such as information concerning hazard insurance and taxes, to the servicer.

76. What will constitute appropriate form of notice to the servicer?

Answer: Delivery to the servicer of a copy of the notice given to the borrower is appropriate notice. The Regulation also provides that the notice can be made either electronically or by a written copy.

77. In the case of a servicer affiliated with the lender, is it necessary to provide the notice?

Answer: Yes. The Act requires the lender to notify the servicer of special flood hazards and the Regulation reflects this requirement. Neither contains an exception for affiliates.

78. How long does the lender have to maintain the record of receipt by the borrower of the notice?

Answer: The record of receipt provided by the borrower must be maintained for the time that the lender owns the loan. Lenders may keep the record in the form that best suits the lender's business practices. Lenders may retain the record electronically, but they must be able to retrieve the record within a reasonable time pursuant to a document request from their Federal supervisory agency.

79. Can a lender rely on a previous notice if it is less than seven years old, and it is the same property, same borrower, and same lender?

Answer: No. The preamble to the Regulation states that subsequent transactions by the same lender with respect to the same property will be treated as a renewal and will require no new determination. However, neither the Regulation nor the preamble addresses waiving the requirement to provide the notice to the borrower. [[Page 35947]] Therefore, the lender must provide a new notice to the borrower, even if a new determination is not required.

80. Is use of the sample form of notice mandatory?

Answer: No. Although lenders are required to provide a notice to a borrower when it makes, increases, extends, or renews a loan secured by an improved structure located in an SFHA, use of the sample form of notice provided in Appendix A of the Regulation or in Appendix 4 of FEMA's Mandatory Purchase of Flood Insurance Guidelines is not mandatory. It should be noted that the sample form includes other information in addition to what is required by the Act and the Regulation. Lenders may personalize, change the format of, and add information to the sample form of notice, if they choose. However, a lender-revised notice must provide the borrower with at least the minimum information required by the Act and Regulation. Therefore, lenders should consult the Act and Regulation to determine the information needed.

XVI. Mandatory Civil Money Penalties

81. Which violations of the Act can result in a mandatory civil money penalty?

Answer: A pattern or practice of violations of any of the following requirements of the Act and their implementing Regulation triggers a mandatory civil money penalty:

Purchase of flood insurance where available (42 U.S.C. 4012a(b));

Escrow of flood insurance premiums (42 U.S.C. 4012a(d));

Force placement of flood insurance (42 U.S.C. 4012a(e));

Notice of special flood hazards and the availability of Federal disaster relief assistance (42 U.S.C. 4104a(a)); and

Notice of servicer and any change of servicer (42 U.S.C. 4101a(b)).

The Act states that any regulated lending institution found to have a pattern or practice of certain violations ``shall be assessed a civil penalty'' by its Federal supervisor in an amount not to exceed $350 per violation, with a ceiling per institution of $100,000 during any calendar year (42 U.S.C. 4012a(f)(5)). Each Agency adjusts these limits pursuant to the Federal Civil Penalties Inflation Adjustment Act of 1990, as amended by the Debt Collection Improvement Act of 1996, 28 U.S.C. 2461 note.\13\ Lenders pay the penalties into the National Flood Mitigation Fund held by the Department of the Treasury for the benefit of FEMA.

\13\ Please refer to 12 CFR 19.240(a) (OCC); 12 CFR 263.65(b)(10) (Board); 12 CFR 308.132(c)(xvi) (FDIC); 12 CFR 509.103(c) (OTS); 12 CFR 622.61(b) (FCA); and 12 CFR 747.1001(a) (NCUA) for the Agencies' current civil penalty limits.

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82. What constitutes a ``pattern or practice'' of violations for which civil money penalties must be imposed under the Act?

Answer: The Act does not define ``pattern or practice.'' The Agencies make a determination of whether a pattern or practice exists by weighing the individual facts and circumstances of each case. In making the determination, the Agencies look both to guidance and experience with determinations of pattern or practice under other regulations (such as Regulation B (Equal Credit Opportunity) and Regulation Z (Truth in Lending)), as well as Agencies' precedents in assessing civil money penalties for flood insurance violations.

The Policy Statement on Discrimination in Lending (Policy Statement) provided the following guidance on what constitutes a pattern or practice:

Isolated, unrelated, or accidental occurrences will not constitute a pattern or practice. However, repeated, intentional, regular, usual, deliberate, or institutionalized practices will almost always constitute a pattern or practice. The totality of the circumstances must be considered when assessing whether a pattern or practice is present.

In determining whether a financial institution has engaged in a pattern or practice of flood insurance violations, the Agencies' considerations may include, but are not limited to, the presence of one or more of the following factors:

Whether the conduct resulted from a common cause or source within the financial institution's control;

Whether the conduct appears to be grounded in a written or unwritten policy or established practice;

Whether the noncompliance occurred over an extended period of time;

The relationship of the instances of noncompliance to one another (for example, whether the instances of noncompliance occurred in the same area of a financial institution's operations);

Whether the number of instances of noncompliance is significant relative to the total number of applicable transactions. (Depending on the circumstances, however, violations that involve only a small percentage of an institution's total activity could constitute a pattern or practice);

Whether a financial institution was cited for violations of the Act and Regulation at prior examinations and the steps taken by the financial institution to correct the identified deficiencies;

Whether a financial institution's internal and/or external audit process had not identified and addressed deficiencies in its flood insurance compliance; and

Whether the financial institution lacks generally effective flood insurance compliance policies and procedures and/or a training program for its employees.

Although these guidelines and considerations are not dispositive of a final resolution, they do serve as a reference point in assessing whether there may be a pattern or practice of violations of the Act and Regulation in a particular case. As previously stated, the presence or absence of one or more of these considerations may not eliminate a finding that a pattern or practice exists.

End of text of the Interagency Questions and Answers Regarding Flood Insurance.

Dated: May 15, 2009.

John C. Dugan,
Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, July 14, 2009.

Jennifer J. Johnson,
Secretary of the Board.

Dated at Washington, DC, this 8th day of July, 2009.

Robert E. Feldman,
Executive Secretary, Federal Deposit Insurance Corporation.

Dated: April 2, 2009.

By the Office of Thrift Supervision.

John E. Bowman,
Acting Director.

Date: July 8, 2009

Roland E. Smith,
Secretary, Farm Credit Administration Board.

By the National Credit Union Administration Board, on June 5, 2009.

Mary F. Rupp,
Secretary of the Board.

[FR Doc. E9-17129 Filed 7-20-09; 8:45 am]

BILLING CODE 4810-33-P

75 FR 50936, 08/18/2010

Handbook Mailing HM-10-9

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 614

RIN 3052-AC60

Loan Policies and Operations; Lending and Leasing Limits and Risk Management

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, Agency, we, our), by the Farm Credit Administration Board, is publishing for comment proposed amendments to our regulations relating to lending and leasing limits. We propose lowering the current limit on extensions of credit to a single borrower for each Farm Credit System (System) institution operating under title I or II of the Farm Credit Act of 1971, as amended (Act). The proposed rule would not affect the lending and leasing limits of title III lenders under § 614.4355. However, we are proposing that all titles I, II and III System institutions adopt written policies to effectively identify, limit, measure and monitor their exposures to loan and lease concentration risks. This proposed rule, if adopted, would increase the safe and sound operation of System institutions by strengthening their risk management practices and abilities to withstand volatile and negative changes in increasingly complex and integrated agricultural markets.

DATES: You may send comments on or before October 18, 2010.

ADDRESSES: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.

- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."

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

- Mail: Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia, or from our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Paul K. Gibbs, Senior Accountant, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090, (703) 883-4498, TTY (703) 883-4434;

or

Wendy R. Laguarda, Assistant General Counsel, Office of General Counsel, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of this proposed rule are to:

- Strengthen the safety and soundness of System institutions;

- Ensure the establishment of consistent, uniform and prudent concentration risk management policies by System institutions;

- Ensure that all System lenders have robust methods to identify, measure, limit and monitor exposures to loan and lease concentration risks, including counterparty risks; and

- Strengthen the ability of System lenders to withstand volatile and negative changes in increasingly complex and integrated agricultural markets.

The proposed regulation would not change the following provisions of the current lending limits rule: definitions under § 614.4350; computation of lending and leasing limit base under § 614.4351; lending and leasing limits for Banks for Cooperatives (BCs) under § 614.4355; BCs look-through notes under § 614.4357; the base calculation for computing the lending and leasing limit under § 614.4358; the attribution rules under § 614.4359; lending and leasing limit violations under § 614.4360; or the transition period prescribed in § 614.4361.[1]

We have elected not to address the lending limits for title III lenders at this time because of the complexity of the issues involved in lending to cooperatives under title III of the Act. Should the Agency decide to address the BCs lending limits at some future time, we will do so in a separate rulemaking.

All System institutions, including title III institutions, would be given 6 months from the effective date of new § 614.4362 to establish and implement written policies on limiting exposures to on- and off-balance sheet loan and lease concentration risks as prescribed therein.

II. Background

The Act[2] does not contain general lending and leasing limits for titles I and II System institutions outside of specific limits for processing and marketing and rural housing loans. However, both the Agency and the System recognize that lending limits are a sound banking practice and an effective risk management tool that enhance the safety and soundness of individual System institutions and the System as a whole. The Agency's current lending limit regulations,[3] promulgated in 1993 with an effective date in 1994, were issued due to the System's structural changes resulting from the Agricultural Credit Act of 1987 (1987 Act).[4] This regulation created a uniform lending limit for all System banks and associations, with the exception of BCs, and for all types of loans and leases. The 25-percent lending limit represented a balance between the Agency's safety and soundness concerns and the System's concerns of being able to service the credit needs of creditworthy, eligible borrowers.[5]

The current regulations do not impose lending limits based on specified risks, such as undue industry concentrations, counterparty risk, ineffective credit administration, participation and syndication activity, inadequate management and accounting practices, or other shortcomings that might have been present in a System institution's financial position or business practices. When the Agency issued the final regulations in 1993, we stated "limiting the amount that can be lent to any one borrower or a group of related borrowers is an effective way to control concentrations of risk in a lending institution and limit the amount of risk to an institution's capital arising from losses incurred by large 'single credits.'"[6] Other than concentration of risk to a single borrower, the Agency left it up to each individual System lender to address industry, counterparty and other concentrations of risk.

III. Proposed Limit on Loans and Leases to One Borrower/Lessee

A. In General

The Agency is proposing to lower the lending and leasing limit on loans and leases (loans) to one borrower or lessee (borrower) for all System institutions operating under title I or II of the Act from the current limit of 25 percent to no more than 15 percent of an institution's lending and leasing limit base. Specifically, FCA proposes to lower the lending and leasing limit in §§ 614.4352, 614.4353 and 614.4356 to 15 percent. We are interested in receiving comments on the implications of this proposed limit for the smallest-sized associations in the System. As noted above, the calculation for the lending and leasing limit base in § 614.4351 would remain unchanged, as would the lending and leasing limit base in § 614.4355 for title III lenders. The proposed 15-percent limit would apply on the date a loan or lease is made and at all times thereafter, with certain exemptions for loans that violate the lending limit as set forth in § 614.4360.[7]

The Agency believes the proposed 15-percent limit is appropriate and necessary for the safe and sound operation of the System, given the changes in the System's structure, growth, authorities and practices since the current regulations became final in 1994. While the proposed 15-percent limit is more in line with the practices of a majority of System lenders, which have established, by policy, internal lending limits well below the current regulatory limit, some System lenders rely on the current 25-percent regulatory limit. Given the extensive System practice of establishing internal hold limits well below the regulatory maximum and the significant concentration risk a 25-percent limit represents, FCA concludes that all System lenders should be required to implement internal lending limits at or below the proposed 15-percent limit based on their institutions' specific circumstances, resources, financial condition, business activities and capability.

B. Substantial Changes in System Structure Since the 25-Percent Limit was Adopted

Since 1994, System banks have shifted their focus from supervising their district associations to operating as funding banks that predominately extend direct loans to, and manage funding for, their district associations. In turn, all associations have become direct lenders, no longer acting as agents for the district banks or relying on district bank policies for their day-to-day operations. During this same time period, the associations have gone through significant restructurings and consolidations. Today, there are fewer than 90 associations in the System and all but a few of them are structured as agricultural credit associations with Federal land credit and production credit association subsidiaries. The proposed 15-percent lower lending limit is more appropriate to these larger consolidated direct lender associations, operating primarily as stand-alone lending institutions with greater lending capacity than ever before.

C. Substantial Growth in System Lending Capacity Since the 25-Percent Limit was Adopted

Coupled with these operational and structural changes, there has been substantial growth in the capital bases of System institutions since 1994, giving them much greater capacity to meet the needs of large borrowers. For example, the median System institutions based on permanent capital totaled $13.7 million at year-end 1994, compared to $98.5 million at year-end 2009. This change represents a 621-percent increase in capital and has increased the 25-percent lending limit amount in the median System institution from $3.4 million to $24.6 million. Additionally, when you compare the 25-percent lending limit amount for the median System institution in 1994 to a 15-percent lending limit amount for a median System institution in 2009, there is effectively a 333-percent increase in the amount of the lending limit due to the increase in the median size of System institutions. Furthermore, when you compare the 25-percent lending limit amount for the smallest and largest System institutions in 1994 to a 15-percent lending limit amount for the smallest and largest System institutions in 2009, there is effectively an increase in the maximum amount of a loan that could be made to a single borrower from $105,000 to $822,000 (a 685-percent increase) for the smallest System institution and from $188 million to $566 million (a 202-percent increase) for the largest System institution.

Accordingly, because of the substantial growth in the System's lending capacity, the current 25-percent lending limit is no longer prudent or necessary to meet the needs of the System's borrowers. While the borrowing needs of the System's largest borrowers have also increased, the tools available to the System today (such as participations, syndications and guarantees) have made it possible to meet those needs with lower, more prudent lending and leasing limits. Such tools can also work to mitigate lending risks by enabling System lenders to share credit risk with each other as well as with other non-System lenders and governmental entities.

D. Majority of System Institution Lending Limit Practices

The Agency has found that a majority of System lenders have implemented internal lending limits at levels not only lower than the current 25-percent regulatory limit but, in many cases, lower than the proposed 15-percent limit. Therefore, the proposed 15-percent limit would be in line with a majority of the current lending practices in the System and, we believe, would not significantly disrupt System institution operations.

The Agency also believes that even with the proposed lower limit of 15 percent, the growth in System capital since 1994 leaves sufficient lending and leasing capacity in the System to adequately serve the credit needs of creditworthy, eligible borrowers.

E. <u>Enhanced System Authorities Since the 25-Percent Limit was First Adopted</u>

Since 1994, System institutions have used the authorities granted under the Act and implemented through FCA regulations to increase their loan portfolios and meet the mission of providing sound, adequate and constructive credit to American agriculture. During this time period, loans to processing and marketing operations have increased to meet the changing nature and needs of farming over the last decade and a half. Likewise, the System's ability to participate and syndicate loans both within and outside of the System has also grown since 1994. System institutions now routinely serve large borrowers by buying and selling participation and syndication interests to other System institutions and other lenders.

The System's lending authorities ensure adequate credit for the next generation of farmers and are necessary for the future of a strong and stable agricultural industry. The System's lending authorities also allow farmers and ranchers to diversify their incomes and financial portfolios. However, the varied loans made for multiple agricultural purposes are not without a degree of risk, particularly when concentrations are not identified, measured, and managed. Similarly, while the System's increased participation and syndication channels reduce the risk of credit to large borrowers and enable System institutions to continue serving such large customers notwithstanding the proposed 15-percent lower lending limit, they also are not without some risk. Such lending channels increase counterparty risks, or those risks created by the potential default of the multiple parties doing business with the System.

Therefore, System institutions must carefully manage and control the counterparty risk posed by purchasing or selling loan exposures through participations or syndications to other System and non-System lenders. With appropriate use and risk controls over syndications and participations, the Agency believes that the proposed 15-percent lower lending limit would reduce the potential risks of all large loans without jeopardizing the System's ability to provide the varied and multiple forms of credit that are necessary in today's agricultural environment.

F. <u>Lending Limits of Other Federally Chartered Lending Institutions</u>

We recognize that a single industry lender like the System is not comparable in many respects to other federally chartered lending institutions with more diverse lending authorities. Consequently, different factors are considered when arriving at a lending limit for the System. Notwithstanding these differences, we note that the 15-percent proposed lower lending limit for the System is comparable to the lending limits of other federally chartered lending institutions.[8] We do not believe, therefore, that the proposed lower limit would put System institutions at a competitive disadvantage in the agricultural lending marketplace.

G. <u>Repeal of § 614.4354</u>

The proposed rule would repeal § 614.4354 pertaining to Federal land bank associations (FLBAs) since such associations have all been converted to direct lending institutions. We note, however, that the repeal of § 614.4354 does not affect, modify, or change in any manner FCA's authority to charter an FLBA without direct lending authority in the future. If we were to issue such a charter at some future point, this provision of the regulation would be repromulgated to establish a lending limit for such an association.

H. <u>Transition Period for Lower Lending Limit</u>

As previously noted, the proposed regulations would not change the existing transition rules in §

614.4361. However, we want to make clear that this section should be read as providing that certain nonconforming loans (including commitments) made or attributed to a borrower prior to the effective date of existing subpart J, or the amendments proposed herein, will not be considered a violation of the lending and leasing limits during the existing contract terms of such loans, provided such loans complied with the regulatory lending limit when made.

IV. Policy on Limiting Exposures to Loan and Lease Concentration Risks

A. In General

In addition to proposing a lower limit on loans to one borrower, FCA is proposing that each System lender's board of directors adopt and ensure implementation of a written policy that would effectively identify, measure, limit and monitor exposures to loan and lease concentration risks. This policy should include both on- and off-balance sheet loan and lease exposures (participation and syndication activity).

The country's recent economic crisis revealed the increasing complexity and volatility of the financial world over the past few decades. The increase in types and complexity of financial instruments – including mortgage-backed securities, collateralized debt obligations and credit default swaps – along with the rise in imprudent home mortgage lending practices helped to create the current instability and uncertainty in the financial lending markets that System institutions, along with all other lenders, are experiencing today.

Like the growing complexity in the financial markets, agricultural markets and industries have also become more complex, integrated, inter-related and potentially turbulent over the years. The System has not been immune to these financial or agricultural instabilities. For instance, the recent financial woes in the biofuels industry (namely ethanol) that the System funded left many System institutions with large troubled loans with related potential loss exposures. Similarly, the recent financial troubles of the largest poultry industry producer in the United States had a domino and damaging effect on contract poultry growers throughout the industry, which demonstrated the impact of concentration risk and ultimately created credit stress in several System institutions. For these reasons, we believe enhanced focus on all loan and lease concentration risks is essential.

B. Safety and Soundness

While many System lenders have adopted policies to manage their exposures to loan concentration risks, a number of institutions do not have any formal or written policies in place. Furthermore, some of those System institutions with established internal concentration limits operate without board policies that adequately address all aspects of identifying, measuring, limiting and monitoring those concentration risks that could adversely impact the institution's financial performance. FCA believes that the proposed policy requirements would ensure a comprehensive approach to mitigating loan and lease concentration risks and would represent a best practice in loan portfolio management. Such policies would help ensure the continuance of a safe and sound System by potentially reducing exposures to concentration risks.

The proposed policy requirement is intended to address vulnerabilities in System loan portfolios resulting from both on- and off-balance sheet loan concentration risks, in particular those concentration risks that are not addressed by the attribution provisions of § 614.4359.

The Agency recognizes that there is not one ideal uniform approach to a loan concentration risk mitigation policy. Accordingly, this proposal outlines only the minimally required elements of such a policy. We have placed substantial responsibility on the board of directors to establish more detailed policies and procedures appropriate to the nature and scope of their institutions' credit activities, territory and risk-bearing capacity. For example, under the category of "other concentration risks," System banks may find it necessary to develop policies that focus on district-wide loan concentrations and on the participation and syndication loans in their portfolios.

C. Policy Elements

In addition to the specific loan and lease concentration risk exposures discussed below under "Quantitative Methods" in Part D, we are proposing to require that the policy include the following elements to ensure that it is properly developed, implemented and monitored:

1. **A clearly defined purpose and objective statement** that sets forth the objectives of the policy and specific means of achieving such objectives. The Agency believes that such a statement would engage System boards of directors in forming a philosophy and direction for the management of their institutions' loan portfolio in the area of concentration risk mitigation.

2. **Clearly defined terms** that are used consistently throughout the policy.

3. **Internal control requirements that:**

a. **Define those authorities delegated to management.** Such requirements should set forth organizational structure and reporting lines that clearly delineate responsibility and accountability for all management functions pertaining to mitigating exposures to both on- and off-balance sheet loan and lease concentration risks, including risk identification, measurement, limitation and oversight. In addition, the policy should establish, when feasible, a separation of duties between personnel executing transactions and those responsible for approval, evaluation and oversight of credit activities. This separation of duties promotes integrity and accuracy in lending practices that reduces the risk of loss. Finally, the policy should cross-reference the conflict of interest regulations in part 612 of this chapter to ensure that employees directly involved in lending and leasing are aware of their responsibilities to disclose actual or apparent conflicts with their official duties.

b. **Define those authorities retained for board action.** Each institution's board of directors has a fiduciary duty to ensure that its institution's lending and leasing activities are prudently managed and in compliance with all applicable laws and regulations. Additionally, the board must ensure that the institution has adequate and qualified personnel to manage the risks associated with its lending and leasing activities. To this end, the Agency encourages each System board of directors to review its loan and lease portfolio concentration risk mitigation policy every year and make any adjustments that are necessary and proper in light of the institution's financial position and the lending environment.

c. **Address exceptions to the policy.** Such procedures should set forth the basis for detecting deviations from, and making exceptions to, the policy requirements. In addition, the policy should describe the duties and responsibilities of management with regard to recommending and reporting on policy deviations or exceptions to the institution's board of directors, including what corrective actions must be taken to restore compliance with the policy. In no event may the lending and leasing limit exceed the applicable regulatory limits for title I, II, or III institutions.

d. **Describe reporting requirements.** Such requirements should describe the content and frequency of the reports and the office or individual(s) responsible for preparing them for an institution's board of directors. The reports should focus on providing information that interprets the data and focuses the board on what is crucial to understand and consider.

D. Quantitative Methods

The Agency is proposing that each policy contain a quantitative method(s) to measure and limit identified exposures to on- and off-balance sheet loan and lease concentrations emanating from:

(i) A single borrower;

(ii) Borrowers in a single sector in the agricultural industry;

(iii) A single counterparty; or

(iv) Unique factors because of the institution's territory, nature and scope of its activities and risk-bearing capacity. Unique concentration exposures might include, but not limited to, borrowers that are reliant on the same processor, marketer, manager, integrator or supplier (or any combination thereof).

Quantitative methods could include hold limits (for example, as a percentage of risk funds, capital, earnings/net income or other appropriate measurements or methods) that reasonably measure and limit concentration risk exposures. We emphasize that the proposed 15-percent regulatory limit on loans to one borrower establishes a ceiling limit. We encourage System institutions to choose more conservative limits on loans to one borrower as a majority of them have done under the current regulatory limit. When arriving at quantitative methods, System institutions should strongly take into account the stability and strength of their capital positions and set their hold limits or other risk management measures accordingly.

The following are examples of concentration risk exposures that might be unique to a lender’s territory:

- An institution has a preponderance of borrowers in its territory that are dependent on off-farm income from the same area manufacturing plant where the potential downsizing or closing of the plant could have a negative effect on loan repayment abilities.

- An institution has a preponderance of independent borrowers selling production to a very limited market (such as farmers selling eggs, sugar beets, cranberries) where a squeeze in the market could have a negative effect on loan repayment abilities.

- An institution has a preponderance of borrowers structured as limited liability companies or partnerships in which the same individuals or group of individuals own interests--not enough to trigger the attribution provisions under this subpart--but enough to create instability among the group of borrowers should the common investors experience financial difficulties.

- An institution has a preponderance of borrowers in a newly emerging market, such as biofuels, which also is an industry outside of the institution’s area of expertise and in which volatile and unforeseen trends in the industry can have a negative effect on loan repayment abilities.

In all the foregoing examples, System institutions should prudently identify, measure, limit and monitor loan concentrations to these groups of borrowers.

In determining concentration risk limits, the policy should take into consideration other risk factors that could reasonably identify foreseeable loan and lease losses. Such risk factors could include borrower risk ratings, the institution's relationship with the borrower, the borrower's knowledge and experience, loan structure, type and location of collateral (including loss given default ratings), loans to emerging industries or industries outside of an institution's area of expertise, out-of-territory loans, counterparties, or weaknesses in due diligence practices. This list is exemplary only and not meant to be exhaustive. The risk factors to be considered by an institution would depend on the unique circumstances of the institution's credit operations.

System institutions should give special consideration to counterparty risks. For example, when entering into a participation, the institution should consider how well it knows and trusts the originator to make full and fair disclosures and to competently service the loan. Conversely, when a System institution originates a participation, it must ensure that there are no material misrepresentations in its disclosures and that it has the ability to properly service the loan. System institution originators should also consider the risk of holding the entire loan should the loan become distressed and the counterparties prevail against the System institution in a lawsuit requiring the System institution to take back the participation. System institutions should consider the risks of concentrating too much of their participation and syndication loans with the same third party. Finally, System institutions should ensure that their policies prudently identify, measure, limit and monitor counterparty exposures with respect to their participation and syndication activity.

We emphasize that robust due diligence practices are especially important when institutions are making loans outside of their territories or core areas of expertise, or with counterparties.

E. Six-Month Timeframe to Issue a Policy

The proposed regulations would require all System lenders (including a title III lender) to establish written loan and lease concentration risk mitigation policies within 6 months from the effective date of these revised regulations. FCA believes that 6 months is a sufficient amount of time for System boards to design and adopt the policy requirements prescribed in new § 614.4362.

V. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), FCA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, Farm Credit System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

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[1] The proposed changes will not change existing regulations covering underwriting standards or lending procedures under § 614.4150.

[2] Pub. L. 92-181, 85 Stat. 583 (Dec. 10, 1971).

[3] See 58 FR 40311, July 28, 1993.

[4]Pub. L. 100-233, 101 Stat. 1568 (Jan. 6, 1988).

[5]See 58 FR 40311, 40318, July 28, 1993.

[6]Id. at 40311.

[7]Section 614.4360 and its stated exemptions from the requirements of § 615.5090 remain unchanged, as noted earlier.

[8]See, e.g., 12 CFR 32.3 (Office of the Comptroller of the Currency); 12 CFR 560.93 (Office of Thrift Supervision); and 12 CFR 701.21 and 12 CFR 723.8 (National Credit Union Administration).

List of Subjects in 12 CFR Part 614

Agriculture, Banks, banking, Foreign trade, Reporting and recordkeeping requirements, Rural areas.

For the reasons stated in the preamble, part 614 of chapter VI, title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 614--LOAN POLICIES AND OPERATIONS

1. The authority citation for part 614 continues to read as follows:

Authority: 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128; secs. 1.3, 1.5, 1.6, 1.7, 1.9, 1.10, 1.11, 2.0, 2.2, 2.3, 2.4, 2.10, 2.12, 2.13, 2.15, 3.0, 3.1, 3.3, 3.7, 3.8, 3.10, 3.20, 3.28, 4.12, 4.12A, 4.13B, 4.14, 4.14A, 4.14C, 4.14D, 4.14E, 4.18, 4.18A, 4.19, 4.25, 4.26, 4.27, 4.28, 4.36, 4.37, 5.9, 5.10, 5.17, 7.0, 7.2, 7.6, 7.8, 7.12, 7.13, 8.0, 8.5 of the Farm Credit Act (12 U.S.C. 2011, 2013, 2014, 2015, 2017, 2018, 2019, 2071, 2073, 2074, 2075, 2091, 2093, 2094, 2097, 2121, 2122, 2124, 2128, 2129, 2131, 2141, 2149, 2183, 2184, 2201, 2202, 2202a, 2202c, 2202d, 2202e, 2206, 2206a, 2207, 2211, 2212, 2213, 2214, 2219a, 2219b, 2243, 2244, 2252, 2279a, 2279a-2, 2279b, 2279c-1, 2279f, 2279f-1, 2279aa, 2279aa-5); sec. 413 of Pub. L. 100-233, 101 Stat. 1568, 1639.

Subpart J--Lending and Leasing Limits

§ 614.4352 [Amended]

2. Section 614.4352 is amended by:

a. Removing the comma after the word "borrower" and removing the number "25" and adding in its place, the number "15" in paragraph (a);

b. Removing the comma after the word "Act" and removing "exceeds 25" and adding in its place "exceed 15" in paragraph (b)(1); and

c. Removing the comma after the word "Act" and removing "exceeds" and adding in its place "exceed" in paragraph (b)(2).

§ 614.4353 [Amended]

3. Section 614.4353 is amended by:

a. Adding the words "direct lender" after the word "No";

b. Removing the comma after the word "borrower"; and

c. Removing "exceeds 25" and adding in its place "exceed 15".

§ 614.4354 [Removed]

4. Section 614.4354 is removed.

§ 614.4356 [Amended]

5. Section 614.4356 is amended by removing the number "25" and adding in its place, the number "15".

6. Section 614.4361 is amended by adding a new paragraph (c) to read as follows:

§ 614.4361 <u>Transition</u>.
*** * * * ***

(c) The loan and lease concentration risk mitigation policy required by § 614.4362 must be adopted and implemented within 6 months from the effective date of such section.

7. A new § 614.4362 is added to subpart J to read as follows:

§ 614.4362 <u>Loan and lease concentration risk mitigation policy</u>.

The board of directors of each System direct lender institution must adopt and ensure implementation of a written policy to effectively measure, limit and monitor exposures to concentration risks resulting from the institution's lending and leasing activities.

(a) *<u>Policy elements</u>.*

(1) The policy must include:

(i) A purpose and objective;

(ii) Clearly defined and consistently used terms;

(iii) Quantitative methods to measure and limit identified exposures to loan and lease concentration risks (as set forth in paragraph (b) of this section); and

(iv) Internal controls that delineate authorities delegated to management, authorities retained by the board, and a process for addressing exceptions and reporting requirements.

(b) *<u>Quantitative methods</u>.*

(1) At a minimum, the quantitative methods included in the policy must quantifiably measure and limit identified concentration risk exposures emanating from:

(i) A single borrower;

(ii) A single industry sector;

(iii) A single counterparty; or

(iv) Other lending activities unique to the institution because of its territory, the nature and scope of its activities and its risk-bearing capacity.

(2) In determining concentration limits, the policy must consider other risk factors that could reasonably identify foreseeable loan and lease losses. Such risk factors could include borrower risk ratings, the institution's relationship with the borrower, the borrower's knowledge and experience, loan structure and purpose, type or location of collateral (including loss given default ratings), loans to emerging industries or industries outside of an institution's area of expertise, out-of-territory loans, counterparties, or weaknesses in due diligence practices.

Date: August 12, 2010

Roland E. Smith,
<u>Secretary</u>,
<u>Farm Credit Administration Board</u>.

76 FR 64175, 10/17/2011

Handbook Mailing HM-11-11

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
[Docket ID OCC-2011-0024]

FEDERAL RESERVE SYSTEM
[Docket No. OP-1431]

FEDERAL DEPOSIT INSURANCE CORPORATION
[RIN 3064-ZA00]

FARM CREDIT ADMINISTRATION
[RIN 3052-AC46]

NATIONAL CREDIT UNION ADMINISTRATION
[RIN 3133-AD41]

Loans in Areas Having Special Flood Hazards; Interagency Questions and Answers Regarding Flood Insurance

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Farm Credit Administration (FCA); National Credit Union Administration (NCUA).

ACTION: Notice and request for comment.

SUMMARY: The OCC, Board, FDIC, FCA, and NCUA (collectively, the Agencies) are finalizing two new questions and answers, one relating to insurable value and one relating to force placement, and withdrawing one question and answer regarding insurable value. The two final questions and answers supplement the "Interagency Questions and Answers Regarding Flood Insurance" (Interagency Questions and Answers), which were published on July 21, 2009 (74 FR 35914). Based on comments received, the Agencies also have significantly revised two questions and answers regarding force placement of flood insurance that were initially proposed on July 21, 2009, and are proposing revision to a previously finalized question and answer. These three revised questions and answers are being proposed for comment.

DATES: Effective date of final questions and answers: October 17, 2011. Comment due date: Comments on the proposed questions and answers must be submitted on or before December 1, 2011.

ADDRESSES: Although the Agencies will jointly review all the comments submitted, it will facilitate review of the comments if interested parties send comments to the agency that is the appropriate federal regulator for the type of institution addressed in the comments. Interested parties are invited to submit written comments to:

OCC: Because paper mail in the Washington, D.C. area and at the Agencies is subject to delay, commenters are encouraged to submit comments by e-mail, if possible. Please use the title "Loans in Areas Having Special Flood Hazards; Interagency Questions and Answers Regarding Flood Insurance" to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- E-mail: regs.comments@occ.treas.gov.
- Mail: Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.
- Fax: (202) 874-5274.
- Hand Delivery/Courier: 250 E Street, SW., Attn: Communications Division, Mail Stop 2-3, Washington, DC 20219.

Instructions: You must include "OCC" as the agency name and "Docket ID OCC-2011-0024" in your comment. In general, the OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this notice by any of the following methods:

- Viewing Comments Personally: You may personally inspect and photocopy comments at the OCC's Communications Division, 250 E Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling in advance (202) 874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.
- Docket: You may also view or request available background documents and project summaries using the methods described above.

Board: You may submit comments, identified by Docket No. OP-1431, by any of the following methods:

- Agency Web Site: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- Federal eRulemaking Portal: http://www.Regulations.gov. Follow the instructions for submitting comments.
- E-mail: regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- Fax: (202) 452-3819 or (202) 452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information.

Public comments may also be viewed electronically or in paper in Room MP–500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

FDIC: You may submit comments, identified by RIN number 3064-ZA00 by any of the following methods:

- Agency Web Site: http://www.fdic.gov/regulations/laws/federal/propose.html. Follow instructions for submitting comments on the Agency Web Site.
- E-mail: Comments@fdic.gov. Include the RIN number in the subject line of the message.
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance

Corporation, 550 17th Street, NW., Washington, DC 20429.

- Hand Delivery/Courier: Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.
- Instructions: All submissions received must include the agency name and RIN number.
- Public Inspection: All comments received will be posted without change to http://www.fdic.gov/regulations/laws/federal/propose.html including any personal information provided. Paper copies of public comments may be ordered from the Public Information Center by telephone at 1-877-275-3342 or 703-562-2200.

FCA: There are several methods for you to submit comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the Agency's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act (29 U.S.C. 794d), we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. FCA requests that comments to the proposed amendment include the reference RIN 3052-AC46. You may submit comments by any of the following methods:

- E-mail: Send us an email at reg-comm@fca.gov.
- Web Site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.Regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102–5090.

You may review copies of all comments we receive at our office in McLean, Virginia, or from our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters" then "Public Comments" and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons, we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

NCUA: You may submit comments by any of the following methods (Please send comments by one method only):

- Federal eRulemaking Portal: http://www.Regulations.gov. Follow the instructions for submitting comments.
- NCUA Web Site: http://www.ncua.gov/RegulationOpinionsLaws/proposed_regs/proposed_regs.html. Follow the instructions for submitting comments.
- E-mail: Address to regcomments@ncua.gov. Include "[Your name] Comments on Flood Insurance, Interagency Questions & Answers" in the e-mail subject line.
- Fax: (703) 518-6319. Use the subject line described above for e-mail.
- Mail: Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.
- Hand Delivery/Courier: Same as mail address.

Public Inspection: All public comments are available on the agency's Web site at http://www.ncua.gov/RegulationOpinionsLaws/comments as submitted, except as may not be possible for technical reasons. Public comments will not be edited to remove any identifying or contact information. Paper copies of comments may be inspected in NCUA's law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment weekdays between 9 a.m. and 3 p.m. To make an appointment, call (703) 518-6546 or send an e-mail to OGCMail@ncua.gov.

FOR FURTHER INFORMATION CONTACT:

OCC: Pamela Mount, National Bank Examiner, Compliance Policy, (202) 874-4428; or Margaret Hesse, Special Counsel, Community and Consumer Law Division, (202) 874-5750, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

Board: Nikita M. Pastor, Senior Attorney, Division of Consumer and Community Affairs, (202) 452-2412; Lanette J. Meister, Senior Supervisory Consumer Financial Services Analyst (202) 452-2705; or Brad Fleetwood, Senior Counsel, Legal Division, (202) 452-3721, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. For the deaf, hard of hearing, and speech impaired only, teletypewriter (TTY), (202) 263-4869.

FDIC: John Jackwood, Senior Policy Analyst, Supervisory Policy Branch, Division of Depositor and Consumer Protection, (202) 898-3991; or Mark Mellon, Counsel, Legal Division, (202) 898-3884, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429. For the hearing impaired only, telecommunications device for the deaf TDD: 800-925-4618.

FCA: Mark L. Johansen, Senior Policy Analyst, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4498, TTY (703) 883-4434; or Mary Alice Donner, Senior Attorney, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4033, TTY (703) 883-4020.

NCUA: Justin M. Anderson, Staff Attorney, Office of General Counsel, (703) 518-6540; or Pamela Yu, Staff Attorney, Office of General Counsel, (703) 518-6593, National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314-3428.

SUPPLEMENTARY INFORMATION:

Background

The National Flood Insurance Reform Act of 1994 (the Reform Act) (Title V of the Riegle Community Development and Regulatory Improvement Act of 1994) comprehensively revised the two federal flood insurance statutes, the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973. The Reform Act required the OCC, Board, FDIC, the Office of Thrift Supervision ("OTS"), and NCUA to revise their flood insurance regulations and required the FCA to promulgate a flood insurance regulation for the first time. The OCC, Board, FDIC, OTS, NCUA, and FCA (collectively, "the Agencies") fulfilled these requirements by issuing a joint final rule in the summer of 1996. *See* 61 FR 45684 (August 29, 1996).[1]

In connection with the 1996 joint rulemaking process, the Agencies received a number of requests to clarify specific issues covering a wide spectrum of the proposed rule's provisions. The Agencies addressed many of these requests in the preamble to the joint final rule. The Agencies concluded, however, that given the number, level of detail, and diversity of the requests, guidance addressing the technical compliance issues would be helpful and appropriate. Consequently, the Agencies decided guidance would be appropriate to address these technical issues subsequent to the promulgation of the final rule (61 FR 45685). The Federal Financial Institutions Examination Council (FFIEC) fulfilled that objective through the initial release of the Interagency Questions and Answers in 1997 (1997 Interagency Questions and Answers). 62 FR 39523 (July 23, 1997).

After notice and comment, on July 21, 2009, the Agencies updated the interagency guidance

(2009 Interagency Questions and Answers). 74 FR 35914 (July 21, 2009). In this publication, the Agencies also proposed five new questions and answers for comment. See 74 FR 35931. The proposed questions and answers addressed issues related to insurable value and force placement of flood insurance.

The Agencies received 28 total comments on the proposed questions and answers. These comments are discussed below.

The Agencies are adopting two of the five questions and answers proposed in the 2009 Interagency Questions and Answers: one question and answer relating to insurable value (question and answer 9) and another question and answer relating to force placement of flood insurance (question and answer 61). The Agencies are also withdrawing one question and answer relating to insurable value and have reserved this question and answer for later use (question and answer 10). However, as discussed below, because the Agencies propose to significantly and substantively change the answers to two of the questions and answers relating to the force placement of flood insurance, the Agencies are proposing them for additional comment (questions and answers 60 and 62). In addition, the Agencies are proposing changes to a previously finalized question and answer (question and answer 57) that also relates to the force placement of flood insurance to be consistent with the proposed changes to these two questions and answers.

The two questions and answers being adopted as final today supplement the 2009 Interagency Questions and Answers and other guidance or interpretations issued by the Agencies and the Federal Emergency Management Agency (FEMA). The Agencies will publish the combined and complete Interagency Questions and Answers in their entirety once the questions and answers that are being proposed for comment are finalized.

For ease of reference, the following terms are used throughout this document: “Act” refers to the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973, as revised by the Reform Act (codified at 42 U.S.C. 4001 *et seq.*). “Regulation” refers to each agency’s current final flood insurance rule.[2]

Final and Withdrawn Questions and Answers

Section II. Determining when certain loans are designated loans for which flood insurance is required under the Act and Regulation.

Insurable value. In general, the questions and answers in Section II explain that, in order to comply with the Regulation, the amount of insurance required is the lesser of the outstanding principal balance of the designated loan or the maximum amount of insurance available under the National Flood Insurance Program (NFIP). The maximum amount of insurance available under the NFIP is the lesser of the maximum limit of coverage available for the particular type of property under the Act or “the overall value of the property securing the designated loan minus the value of the land on which the property is located.” Consistent with terminology used by FEMA in its guidance, the Agencies use the term “insurable value” to denote the regulatory phrase “overall value of the property minus the value of the land.” See generally question and answer 8.

The Agencies proposed questions and answers 9 and 10 in an effort to assist lenders in calculating the “insurable value” of a property for purposes of determining the required amount of flood insurance under the NFIP. Proposed question and answer 9 referenced FEMA guidelines in providing that the full insurable value of a building is the same as 100 percent replacement cost value (RCV)[3] of the insured building. Proposed question and answer 9 sought to illustrate the flexibility lenders have in determining RCV of a building by providing that lenders (either by themselves or in consultation with the flood insurance provider or other professionals) could consider permissible methods, such as the RCV used in a hazard insurance policy (recognizing that replacement cost for flood insurance will include the foundation), an appraisal based on a cost-value (not market-value) approach before depreciation deductions, and/or a construction cost calculation.

Proposed question and answer 10 provided alternatives to determining the insurable value other than RCV for certain nonresidential buildings used for ranching, farming, and industrial purposes when the borrower either would replace the building with a structure more closely aligned with the function the building is presently providing or would not replace the building if damaged or destroyed by a flood. In such cases, the alternatives proposed by the Agencies would have allowed the lender to determine the insurable value by either the "functional building cost value" or by the demolition/removal cost value.

Comments and Final Question and Answer 9

Although the Agencies received several comments commending the proposed guidance, numerous commenters objected to tying insurable value to RCV in all cases. Commenters stated that it was not possible to obtain RCV in many instances, particularly in cases of nonresidential properties. Commenters also stated that reliance on RCV was inappropriate for nonresidential properties because borrowers would only recover actual cash value[4] in the event of a loss for these types of properties, resulting in the borrower being over-insured.

In response, the Agencies reaffirm that the insurable value for certain residential or condominium properties should be written to RCV. Further, the Agencies recognize that this strict interpretation of insurable value as RCV may not be practical in all cases for nonresidential buildings. Although FEMA's guidance states that insurable value is the same as RCV, it also provides that lenders should avoid creating a situation in which the insured pays for coverage that exceeds the amount the NFIP will pay in the event of a loss.[5] In cases involving certain residential or condominium properties,[6] insurance policies should be written to, and the insurance loss payout would be the equivalent of, RCV. However, in cases involving nonresidential properties, as well as some residential properties, where the insurance loss payout is normally based on actual cash value, insurance policies written at RCV may require an insured to pay for coverage that significantly exceeds the amount the NFIP would pay in the event of a loss. Similarly, in the case of certain nonresidential buildings used for ranching, farming, or industrial purposes that the borrower either would not replace if damaged or destroyed by a flood or would replace with a structure more closely aligned to the function the building is providing at the time of the flood, payouts may be well below RCV. Further, in cases where the physical depreciation of a nonresidential building is very high, the actual cash value payout would likely be very low, causing an even larger gap in the amount of insurance purchased and the potential payout. As a result, requiring flood insurance equal to RCV in such instances may lead to over-insurance for such properties. Lenders, however, need to be equally mindful of avoiding situations in which, as a result of insuring at a level below RCV, they under-insure property. In determining the amount of insurance to require, lenders should consider the extent of recovery allowed under the applicable NFIP policy.

Given these practical considerations, the Agencies are adopting question and answer 9 with a revision to provide that, in calculating the required amount of insurance, the lender and borrower (either by themselves or in consultation with the flood insurance provider or other appropriate professional) may choose from a variety of approaches or methods to establish a reasonable valuation. They may use an appraisal based on a cost-value (not market-value) approach, a construction-cost calculation, the insurable value used in a hazard insurance policy (recognizing that the insurable value for flood insurance purposes may differ from the coverage provided by the hazard insurance and that adjustments may be necessary;

for example, most hazard policies do not cover foundations), or any other reasonable approach, so long as it can be supported. It is important for lenders to recognize that, when calculating the minimum amount of insurance that is required to be purchased, the insurable value is only relevant to the extent that it is lower than either the outstanding principal balance of the loan or the maximum amount of insurance available under the NFIP.

Withdrawn Question and Answer 10

In light of the alternative approaches suggested in final question and answer 9, the Agencies believe the specific exceptions to insurable value in proposed question and answer 10 are no longer necessary. As a result, the Agencies are withdrawing question and answer 10 and that number is reserved for future use.

Section X. Force placement of flood insurance

Section X addressed issues concerning the force placement of flood insurance. The section and the accompanying questions and answers were originally adopted in the 1997 Interagency Questions and Answers. The Agencies proposed changes to those existing questions and answers in March 2008 designed to provide greater clarity with no intended change in substance and meaning. These revisions were adopted in July 2009. In response to comments received, however, the Agencies proposed three new questions and answers (60, 61, and 62). These proposed questions and answers addressed the following force placement issues: when the 45-day notice period should begin, whether a borrower may be charged for the cost of flood insurance coverage during the 45-day notice period, and how soon after the end of the notice period a lender should purchase a flood insurance policy when the borrower has failed to purchase an appropriate policy.

The Agencies are adopting question and answer 61 as final, with minor nonsubstantive clarifications. However, after consideration of the comments received on questions and answers 60 and 62, the Agencies are revising these proposed questions and answers for further comment. The Agencies are also proposing revisions to question and answer 57 to make it consistent with proposed questions and answers 60 and 62.

Comments and Final Question and Answer 61

The Agencies proposed new question and answer 61 to address questions and concerns about how soon lenders have to force place insurance after the end of the 45-day notice period. The Regulation provides that the lender or its servicer shall purchase insurance on the borrower’s behalf if the borrower fails to obtain flood insurance within 45 days after notification. Proposed question and answer 61 stated that, given that the lender is already aware during the 45-day notice period that it may be required to force place insurance if there is no response from the borrower, any delay in force placing flood insurance should be brief. Where there is a brief delay in force placing required insurance, the proposed question and answer stated that the Agencies will expect the lender to provide a reasonable explanation for the delay.

The Agencies received comments from six commenters addressing proposed question and answer 61. Two lender commenters explained that batch processing of force placed flood insurance policies may cause a brief delay in the completion of the force placement process. They requested that the Agencies specify in the answer that, if a policy is in effect, for example, five days after the end of the 45-day notice period, then the force placement time frame has been satisfied. The Agencies decline to set an arbitrary number of days after the end of the 45-day notice period as a “safe harbor” for completion of the force placement process. The Agencies believe that the lender should have policies and procedures in place to allow force placement generally to commence when the 45-day notice period has expired. However, the Agencies also recognize that the process of force placing flood insurance may not always occur immediately on the 46th day. If there is a brief delay in force placing the required insurance, the lender should be able to provide a reasonable explanation for the delay.

A government-sponsored enterprise (GSE) commenter did not agree with allowing a brief delay, even if the lender could provide a reasonable explanation, noting that flood insurance coverage is required at all times during the term of the mortgage. This commenter also expressed concern over the concept of the 45-day notice period, which results in the unintended consequence that properties may be uninsured or under-insured during the term of the loan. The Agencies are unable to address this overall concern, given that the 45-day notice requirement is found in the Act.

The Agencies are adopting final question and answer 61 with minor nonsubstantive clarifications.

Revised Proposed Questions and Answers

Section X. Force placement of flood insurance

Section X addressed issues concerning the force placement of flood insurance. As noted above, the Agencies have revised and are re-proposing question and answer 60, which addresses when a lender should send the force-placement notice, and question and answer 62, which addresses when a lender may charge a borrower for the cost of flood insurance during the 45-day notice period. The Agencies are also proposing revisions to final question and answer 57 in consideration of the proposed revisions to questions and answers 60 and 62.

Comments and Revised Proposed Question and Answer 60

On July 21, 2009, the Agencies proposed question and answer 60 to address the permissibility of a lender's acceleration of the 45-day notice period for force placement by sending notice to the borrower before the borrower's flood insurance coverage expires. The Act provides that a lender or its servicer must notify a borrower if it determines that the improved real estate collateral's insurance coverage has expired or is less than the amount required for that particular property. The Act further provides that if the borrower fails to purchase flood insurance within 45 days of such notice, the lender or servicer is required to purchase the insurance on behalf of the borrower. See 42 U.S.C. 4012a(e)(1) & (2). The proposed answer to question 60 stated that although a lender or servicer could send an advance notice, the Act and Regulation do not allow a lender or its servicer to shorten the 45-day force-placement notice period by sending a notice to the borrower prior to the actual expiration date of the flood insurance policy. The proposed answer also provided that the notice must allow the borrower 45 days in which to obtain flood insurance.

The Agencies received a number of comments on this question and answer. A few commenters generally agreed with the proposed answer to question 60; however, the majority of the commenters viewed the proposed question and answer as thwarting the flood insurance program's primary purpose of ensuring continuous flood insurance coverage during the life of the loan.

Some commenters asserted that the proposed question and answer contradicted the NFIP Flood Insurance Manual, which requires flood insurance protection for the life of the loan and states that renewal/expiration letters should be sent not less than 45 days before policy expiration. However, that discussion referenced in the manual pertains to the renewal notice that is sent by an insurance company to policyholders, reminding them that their flood insurance coverage is about to lapse. As such, it has no application to the question and answer, which pertains to the notice that a lender or its servicer is required to send to borrowers once the lender or its servicer has made a determination that flood insurance coverage has either lapsed or is inadequate.

The Agencies agree with the commenters that the purpose of the notice process is to ensure that there is continuous flood insurance coverage during the life of the loan. In considering these comments to proposed question and answer 60, the Agencies have sought to reconcile the statute's requirement that a lender send the borrower notice of inadequate or lapsed flood insurance with the purpose of the statute to facilitate a lender or servicer's ability to ensure continuous flood insurance coverage. The Agencies are, therefore, proposing revisions to question and answer 60 to clarify when a lender is required to send a force placement notice to the borrower to ensure adequate flood insurance coverage is maintained throughout the term of the loan. The revisions to the question and answer are further made in recognition of the position, set out in the revisions to proposed question and answer 62 *infra*, that lenders may force place flood insurance coverage for any part of the 45-day notice period in which no adequate borrower-purchased flood insurance is in effect and charge the borrower for the costs of such coverage, if the borrower has given the lender express authority as a contractual condition of the loan being made.

The text of the revised proposed question and answer is as follows:

60. When should a lender send the force placement notice to the borrower?

Answer: To ensure that adequate flood insurance coverage is maintained throughout the term of the loan, a lender or its servicer must notify a borrower whenever flood insurance on the collateral has expired or is less than the amount required for the property. The lender must send this notice upon making a determination that the flood insurance coverage is inadequate or has expired, such as upon receipt of the notice of cancellation or expiration from the insurance provider or as a result of an internal flood policy monitoring system. Notice is also required when a lender learns that a property requires flood insurance coverage because it is in an SFHA as a result of a flood map change (which is occurring in many communities as a result of FEMA's map modernization program). To avoid the expiration of insurance, the Agencies recommend that the lender also advise the borrower when flood insurance on the collateral is about to expire.

Comments on Revised Proposed Question and Answer 62

On July 21, 2009, the Agencies proposed question and answer 62 to address whether a borrower may ever be charged for the cost of flood insurance that provides coverage for the 45-day force-placement notice period. The Agencies received comments from 19 commenters regarding the proposed question and answer. Of these, a majority disagreed with the proposition that a lender or servicer has no authority to charge a borrower for coverage that applies to the notice period. One commenter favored the question and answer, but noted that gaps in coverage and costly administration of the notice requirements would be eliminated if lenders escrowed flood insurance premiums, even though not legally required to do so. Another commenter had no objection to the proposed question and answer.

Several commenters reasoned that the Act intended to establish a goal of continuous coverage throughout the life of a mortgage loan. These commenters contended that question and answer 62 would undercut this primary goal if finalized as proposed.

Commenters also contended that a borrower must maintain flood insurance at the borrower's expense throughout the life of the loan. They argued that it is in the borrower's best interest if flood insurance coverage on the collateral is purchased by the lender during the 45-day notice period after a policy lapses if a borrower has not renewed the policy or otherwise purchased insurance. A commenter contended that it is fair and equitable that borrowers should pay for continuous coverage. Some commenters also noted that the Act expressly allows a lender to charge a borrower for the cost of premiums and fees incurred in purchasing insurance. One commenter argued it would further safety and soundness principles to allow a lender or a servicer to charge a borrower for the cost of flood insurance during the notice period because, otherwise, the lender may not purchase such coverage if it could not recoup its cost. Another commenter did not address the proposed question and answer directly, but did argue for continuous flood insurance coverage throughout the life of a mortgage, including the notice period, citing potential significant financial risk to a borrower during that time.

Some commenters acknowledged that the Act does not specifically authorize a lender or a servicer to charge a borrower for a force-placed policy until the notice period has expired. However, these commenters contended that, absent a specific prohibition on charging borrowers for coverage for the 45-day notice period, lenders should be permitted to charge borrowers for such coverage.

Several commenters contended that most loan agreements generally prohibit any gap in flood insurance coverage and authorize a lender to force place insurance on the collateral if the borrower fails to maintain coverage. One commenter advised that the proposed question and answer would interfere with the borrower-lender contractual relationship and also with the purpose of the Act by prohibiting lenders from relying on the authority granted in their loan documents to force place flood coverage.

One commenter noted that a policy force-placed through the NFIP is not available until the expiration of the notice period; others contended that private insurers offer force-placed coverage effective retroactively to the date of the lapse to avoid any uninsured loss. With respect to coverage during the notice period, one commenter noted that, if retroactive coverage to the date of lapse is not permitted for a force-placed private insurance policy, the lender (and the borrower) will be exposed to loss. Several commenters noted that the lender would be exposed to at least a 15-day lapse in coverage under an NFIP policy because the lender's coverage continues for only 30 days after lapse, not 45.

Several commenters maintained that proposed question and answer 62 could harm borrowers. Commenters argued that a borrower would not have to pay for duplicate coverage under most force-placed policies. They contended that an insurer would waive or refund the premiums for force-placed insurance if the borrower establishes that coverage is already in place or was obtained during the notice period. Several commenters even argued that the proposed question and answer might encourage a "free-rider situation" in which borrowers may delay renewal or even cancel policies since they cannot be charged during the notice period.

A few commenters argued that proposed question and answer 62 could lead to increased losses for the NFIP since lenders would submit more claims under the mortgagee clauses of the NFIP policy for losses that occur during the notice period instead of submitting them to a private force-placed policy. The same commenters maintained that smaller lenders may not be able to afford the cost of blanket or force-placed policies and will allow collateral to remain uninsured for the gap period, contrary to safety and soundness principles.

In consideration of the comments received, the Agencies are revising proposed question and answer 62. As a general rule, the revised proposed question and answer would allow a lender or its servicer to charge a borrower for insurance coverage for any part of the 45-day notice period in which no adequate borrower-purchased flood insurance coverage is in effect <u>if</u> the borrower has given the lender or its servicer the express authority to charge the borrower for such coverage as a contractual condition of the loan being made. Any policy that is obtained by a lender or its servicer, the premium of which is charged to the borrower pursuant to a contractual right, should be equivalent in coverage and exclusions to an NFIP policy and cover the interests of both the borrower and the lender.

In the proposed question and answer, the Agencies also encourage institutions to explain their force-placement policies to borrowers (including their policy on charging for force-placement coverage for the 45-day period and the timing of that charge) and encourage lenders and servicers to escrow flood insurance premiums. Following these recommendations could result in significantly less force placement of flood insurance. The Agencies also note in the proposed question and answer that Regulation Z requires lenders to establish an escrow account for the payment of property taxes and mortgage-related insurance required by the lender, including flood insurance, for all "higher priced" first-lien mortgage loans. *See* 12 CFR 226.35(b)(3).[7]

The text of the revised proposed question and answer follows:

62. When may a lender or its servicer charge a borrower for the cost of insurance that covers collateral during the 45-day notice period?

Answer: A lender or its servicer may charge a borrower for insurance coverage for any part of the 45-day notice period in which no adequate borrower-purchased flood insurance coverage is in effect, if the borrower has given the lender or its servicer the express authority to charge the borrower for such coverage as a contractual condition of the loan being made. Any policy that is obtained by a lender or its servicer, the premium of which is charged to the borrower pursuant to a contractual right, should be equivalent in coverage and exclusions to an NFIP policy and cover the interests of both the borrower and the lender.

The Agencies encourage institutions to explain their force-placement policies to borrowers (including their policy on charging for force-placement coverage for the 45-day period and the timing of that charge) and encourage lenders and servicers to escrow flood insurance premiums. Following these recommendations could result in less force placement of flood insurance. Further, Regulation Z requires lenders to establish an escrow account for the payment of property taxes and mortgage-related insurance required by the lender, including flood insurance, for all "higher priced" first-lien mortgage loans. See 12 CFR 226.35(b)(3).

Revised proposed Question and Answer 57

Proposed question and answer 57 provides general guidance on force placement under the Act and Regulation. The Agencies are proposing revisions to previously finalized question and answer 57 as a result of the proposed revisions to questions and answers 60 and 62. The proposed revisions to question and answer 57 clarify when a lender is required to send a force-placement notice to the borrower to ensure adequate flood insurance coverage is maintained throughout the term of the loan. The proposed revisions also clarify best practices that lenders should follow in providing borrowers with useful information in the force-placement notice to assist them in understanding the high costs of premiums and fees in connection with force-placed insurance coverage. The revised question and answer also encourages lenders, in situations where a borrower has not previously been required to have flood insurance (such as a map change), to send borrowers the Notice of Special Flood Hazards and Availability of Federal Disaster Assistance with the force-placement notice to give borrowers important information about the implications of being in a SFHA.

The text of the revised proposed question and answer is as follows:

57. What is the requirement for the force placement of flood insurance under the Act and Regulation?

Answer: The Act and Regulation require a lender to force place flood insurance, if all of the following circumstances occur:

- The lender determines at any time during the life of the loan that the property securing the loan is located in an SFHA;
- Flood insurance under the Act is available for improved property securing the loan;
- The lender determines that flood insurance coverage is inadequate or does not exist; and
- After required notice, the borrower fails to purchase the appropriate amount of coverage within 45 days.

The Act and Regulation require the lender, or its servicer, to send notice to the borrower upon making a determination that the improved real estate collateral's insurance coverage has expired or is less than the amount required for that particular property, such as upon receipt of the notice of cancellation or expiration from the insurance provider. The Act and Regulation also require the lender, or its servicer, to give notice and force-place such insurance, if necessary, when a lender learns that a property requires flood insurance coverage because it is in a SFHA as a result of a flood map change (which is occurring in many communities as a result of FEMA's map modernization program).

The notice to the borrower must clearly state that the borrower should obtain, at the borrower's expense, flood insurance in an amount at least equal to the amount required under the NFIP, for the remainder of the loan's term. The notice should also state that if the borrower does not obtain the insurance within 45-days, the lender will purchase the insurance on behalf of the borrower and may charge the borrower for the cost of premiums and fees to obtain the coverage, which are likely to be more expensive than if the borrower purchases it. The Agencies encourage institutions to explain their force-placement policies to borrowers (including, where applicable, that they charge for force-placement coverage for the 45-day period and the timing of that charge). In situations where a borrower has not previously been required to have flood insurance (such as a map change), it is a best practice to also provide the Notice of Special Flood Hazards and Availability of Federal Disaster Assistance, which give borrowers important information about the implications of being in a SFHA.

If adequate insurance is not obtained by the borrower within the 45-day notice period, then the lender must purchase insurance on the borrower's behalf. Standard Fannie Mae/Freddie Mac documents permit the servicer or lender to add those charges to the principal amount of the loan.

FEMA developed the Mortgage Portfolio Protection Program (MPPP) to assist lenders in connection with force-placement procedures. FEMA published these procedures in the Federal Register on August 29, 1995 (60 FR 44881). Appendix A of FEMA's September 2007 *Mandatory Purchase of Flood Insurance Guidelines* sets out the MPPP Guidelines and Requirements, including force-placement procedures and examples of notification letters to be used in connection with the MPPP.

Public Comments

The Agencies invite specific public comment on proposed questions and answers 57, 60, and 62 and are particularly interested in comments regarding proposed question and answer 62. With regard to proposed question and answer 62, the Agencies note that question and answer 62 being proposed today reaches a conclusion that is significantly different from the guidance proposed in July 2009. In the July 2009 proposed guidance, proposed question and answer 62 stated that a lender or its servicer does not have the authority to charge a borrower for the cost of insurance coverage during the 45-day notice period. However, in recognition of standard provisions in many contracts entered into between borrowers and lenders at loan origination, the Agencies are now proposing guidance allowing lenders, or servicers acting on behalf of lenders, to charge a borrower for insurance coverage for any part of the 45-day notice period in which no adequate borrower-purchased flood insurance coverage is in effect if the borrower has given the lender or its servicer the express authority to charge the borrower for such coverage as a contractual condition of the loan being made.

The Agencies are concerned that borrowers are not adequately aware of the higher costs of lender-placed flood insurance. In addition, the Agencies are concerned that borrowers may not be aware that lender force placement may occur during the 45-day notice period and that the borrower could be charged for such coverage. The Agencies invite comment on how to address these concerns and on whether they should adopt question and answer 62 as proposed. The Agencies also seek comment on whether there are alternative approaches that would appropriately balance the borrower's right to obtain flood insurance at any time during the 45-day period after notification and avoid force placement with the lender's need to protect itself during that period and to be compensated for lender-purchased insurance.

The Agencies note that an NFIP flood insurance policy provides coverage for the mortgagee for 30 days after lapse. Proposed question and answer 62 does not directly address whether a lender may charge the borrower for coverage during the 30 days after lapse of the borrower-purchased NFIP policy, during which time the policy is still in effect, other than stating that the lender may charge a borrower for insurance coverage for any part of the 45-day notice period in which no adequate borrower-purchased flood insurance coverage is in effect. The Agencies also seek comment on whether any final question and answer on this issue should provide that lenders may not charge for additional overlapping lender-placed coverage during that 30-day period.

Finally, the Agencies note that there are a number of recent developments relating to force-placed insurance on consumer mortgages. For example, Congress recently set forth notice and force-placement requirements for hazard insurance in section 1463 of the Dodd–Frank Act, which amends the Real Estate Settlement Procedures Act of 1974. While section 1463 is still awaiting regulatory implementation, the statutory language provides that a servicer of a federally related mortgage may not impose any charge on any borrower for force-placed hazard insurance unless the servicer has sent the borrower two separate notices within a 45-day period and has not received confirmation from the borrower that such insurance has been obtained during that period. The Agencies note that section 1463 of the Dodd–Frank Act does not cover the force placement of flood insurance. Force-placement of insurance also has been raised as a significant concern in connection with recent foreclosure activity. The Agencies will continue to monitor developments in this area to the extent that they can inform agencies' supervisory policy with regard to the Act rules.

If financial institutions, bank examiners, community groups, or other interested parties have unanswered questions or comments about the Agencies' flood insurance regulation, they should submit them to the Agencies. The Agencies will consider addressing these questions in future guidance.

Solicitation of Comments Regarding the Use of "Plain Language"

Section 722 of the Gramm–Leach–Bliley Act of 1999, 12 U.S.C. 4809, requires the federal banking Agencies to use "plain language" in all proposed and final rules published after January 1, 2000. Although this document is not a proposed rule, comments are nevertheless invited on whether the proposed questions and answers are stated clearly and how they might be revised to be easier to read.

The text of the new final Questions and Answers follows:

Interagency Questions and Answers Regarding Flood Insurance

* * * * *

II. Determining the appropriate amount of flood insurance required under the Act and Regulation

* * * * *

9. *<u>What is the "insurable value" of a building?</u>*

Answer: The insurable value of a building is the same as the overall value of a property minus the land on which the property is located. FEMA's *Mandatory Purchase of Flood Insurance Guidelines* state that the insurable value of a building is the same as 100 percent replacement cost value (RCV) of the insured building, which is defined as "[t] he cost to replace property with the same kind of material and construction without deduction for depreciation."[8] FEMA's guidelines, however, also provide that lenders should avoid creating a situation in which the insured pays for more coverage than the NFIP would pay in the event of a loss.[9] Strictly linking insurable value to RCV is not practical in all cases. In cases involving certain residential or condominium properties, insurance policies should be written to, and the insurance loss payout usually would be the equivalent of, RCV.[10] However, in cases involving nonresidential properties, and even some residential properties, where the insurance loss payout would normally be based on actual cash value, which is RCV less physical depreciation,[11] insurance policies written at RCV may require an insured to pay for coverage that exceeds the amount the NFIP would pay in the event of a loss. Therefore, it is reasonable for lenders, in determining the amount of flood insurance required, to consider the extent of recovery allowed under the NFIP policy for the type of property being insured. This allows the lender to assist the borrower in avoiding situations in which the insured pays for coverage that exceeds the amount the NFIP will pay in the event of a loss. Lenders need to be equally mindful of avoiding situations in which, as a result of insuring at a level below RCV, they underinsure property.

In calculating the amount of insurance to require, the lender and borrower (either by themselves or in consultation with the flood insurance provider or other appropriate professional) may choose from a variety of approaches or methods to establish the insurable value. They may use an appraisal based on a cost-value (not market-value) approach, a construction-cost calculation, the insurable value used in a hazard insurance policy (recognizing that the insurable value for flood insurance purposes may differ from the coverage provided by the hazard insurance and that adjustments may be necessary; for example, most hazard policies do not cover foundations), or any other reasonable approach, so long as it can be supported.

10. *<u>[Reserved]</u>*

Answer: <u>[Reserved]</u>

* * * * *

X. Force placement of flood insurance

* * * * *

57. *What is the requirement for the force placement of flood insurance under the Act and Regulation?*

Answer: [Reserved]

60. *When should a lender send the force-placement notice to the borrower?*

Answer: [Reserved]

61. *When must the lender have flood insurance in place if the borrower has not obtained adequate insurance within the 45-day notice period?*

Answer: The Regulation provides that the lender or its servicer shall purchase insurance on the borrower's behalf if the borrower fails to obtain flood insurance within 45 days after notification. However, where there is a brief delay in force placing required insurance, the Agencies will expect the lender to provide a reasonable explanation for the delay, for example, where a lender uses batch processing to purchase force-placed flood insurance policies.

62. *When may a lender or its servicer charge a borrower for the cost of insurance that covers collateral during the 45-day notice period?*

Answer: [Reserved]

* * * * *

Dated: June 28, 2011

John Walsh,
Acting Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, September 30, 2011.

Jennifer J. Johnson,
Secretary of the Board.

Dated at Washington, D.C., this 11th day of October, 2011.

FEDERAL DEPOSIT INSURANCE CORPORATION

Valerie J. Best,
Assistant Executive Secretary.

Date: October 5, 2011

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.

By the National Credit Union Administration Board, on October 3, 2011.

Mary F. Rupp,
Secretary of the Board.

[1] Throughout this document "the Agencies" includes the OTS with respect to events that occurred prior to July 21, 2011, but does not include OTS with respect to events thereafter. Sections 311 and 312 of the Dodd-Frank Wall Street Reform and Consumer Protection Act transferred OTS's functions to other agencies on July 21, 2011. The OTS's supervisory functions relating to Federal savings associations were transferred to the OCC, while those relating to state savings associations were transferred to the FDIC. See also 76 FR 39246 (Jul. 6, 2011).

[2] The Agencies' rules are codified at 12 CFR part 22 (national banks) and 76 FR 48,950, 49,140 (Aug. 9, 2011) (to be codified at 12 CFR part 172) (Federal savings associations) (OCC), 12 CFR part 208 (Board), 12 CFR part 339 (state nonmember banks) and 76 FR 47,822 (Aug. 5, 2011) (to be codified at 12 CFR part 391 subpart D) (state savings associations) (FDIC), 12 CFR part 614 (FCA), and 12 CFR part 760 (NCUA). OTS's rules at 12 CFR part 572 will be removed from codification at a later date.

[3] RCV is the cost to replace property with the same kind of material and construction without deduction for depreciation. FEMA, *Mandatory Purchase of Flood Insurance Guidelines,* at GLS 10.

[4] "Actual cash value" is the cost to replace an insured item of property at the time of loss, less the value of its physical depreciation. FEMA, *Mandatory Purchase of Flood Insurance Guidelines*, at GLS 1.

[5] FEMA, *Mandatory Purchase of Flood Insurance Guidelines*, at 27.

[6] A single-family dwelling, including a single-family unit in a building under a condominium form of ownership, used as the insured's primary residence is covered under the NFIP's Dwelling Policy and, upon loss, payment is settled at RCV if the dwelling is insured for at least the lesser of 80 percent of the dwelling's full RCV or the maximum limit of coverage under the NFIP. Losses on other residential properties are settled at actual cash value. *See* FEMA, *Flood Insurance Manual*, at POL 3-20. Residential condominium buildings are covered under the NFIP's Residential Condominium Building Association Policy (RCBAP). Losses on residential condominium buildings are settled at RCV, unless subject to a co-insurance penalty, which applies when the building coverage is less than the lesser of 80 percent of full RCV or the maximum limit of coverage under the NFIP. *See id.* at POL 43-60.

[7] Institutions should note that upcoming rules to implement section 1461 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203) (Dodd–Frank Act), may affect the portion of the answer referencing mandatory escrow requirements for flood insurance.

[8] FEMA, *Mandatory Purchase of Flood Insurance Guidelines,* at GLS 10.

[9] FEMA, *Mandatory Purchase of Flood Insurance Guidelines*, at 27.

[10] A single-family dwelling, including a single-family unit in a building under a condominium form of ownership, used as the insured's primary residence is covered under the NFIP's Dwelling Policy and, upon loss, payment is settled at RCV if the dwelling is insured for at least the lesser of 80 percent of the dwelling's full RCV or the maximum limit of coverage under the NFIP. Losses on other residential properties are settled at actual cash value. *See* FEMA, *Flood Insurance Manual*, at POL 3-20. Residential condominium buildings are covered under the NFIP's Residential Condominium Building Association Policy (RCBAP). Losses on residential condominium buildings are settled at RCV, unless subject to a co-insurance penalty, which applies when the building coverage is less than the lesser of 80

percent of full RCV or the maximum limit of coverage under the NFIP. *See id.* at POL 43-60.

[11] FEMA, *Mandatory Purchase of Flood Insurance Guidelines*, at GLS 1.

76 FR 29992, 05/24/2011

Handbook Mailing HM-11-4

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 614

RIN 3052-AC60

Loan Policies and Operations; Lending and Leasing Limits and Risk Management

AGENCY: Farm Credit Administration.

ACTION: Final rule.

SUMMARY: The Farm Credit Administration (FCA, Agency, we, our) issues this final rule amending our regulations relating to lending and leasing limits (lending limits) and loan and lease concentration risk mitigation (risk mitigation) with a delayed effective date. The final rule lowers the limit on extensions of credit to a single borrower or lessee (collectively borrower) for each Farm Credit System (System) institution operating under title I or II of the Farm Credit Act of 1971, as amended (Act). This final rule also adds new regulations requiring all titles I, II, and III System institutions to adopt written policies to effectively identify, limit, measure and monitor their exposures to loan and lease (collectively loan) concentration risks. We expect this final rule will increase the safe and sound operation of System institutions by strengthening their risk mitigation practices and abilities to withstand volatile and negative changes in increasingly complex and integrated agricultural markets.

EFFECTIVE DATE: This regulation will be effective on July 1, 2012, provided either or both Houses of Congress are in session for at least 30 calendar days after publication of this regulation in the *Federal Register*. We will publish a notice of the effective date in the *Federal Register*.

FOR FURTHER INFORMATION CONTACT:

Paul K. Gibbs, Senior Accountant, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090, (703) 883-4498, TTY (703) 883-4434;

or

Wendy R. Laguarda, Assistant General Counsel, Office of General Counsel, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of this final rule are to:

- Strengthen the safety and soundness of System institutions;
- Ensure the establishment of consistent, uniform and prudent loan and lease concentration risk mitigation policies by System institutions;
- Ensure that all System lenders have robust methods to measure, limit and monitor reasonably foreseeable exposures to loan and lease concentration risks, including counterparty risks; and
- Strengthen the ability of System lenders to withstand volatile and negative changes in increasingly complex and integrated agricultural markets.

II. Background

On August 18, 2010, the FCA published a proposed rule (75 FR 50936) in the *Federal Register* to lower the lending limit on loans and leases to one borrower for all System institutions operating under title I or II of the Act from the current limit of 25 percent to a limit of no more than 15 percent of an institution's lending limit base. We further proposed that each title I, II and III System institution's board of directors adopt and ensure implementation of a written policy that would effectively measure, limit and monitor exposures to loan concentration risks.

III. Comments on the Proposed Rule and Our Responses

A. In General

The FCA received a total of six comment letters, including five from System associations and one from the System's trade association. No comment letters were received from outside of the System. In addition, FCA personnel had substantive oral communications during the comment period with the signatories of two of the comment letters regarding clarification of their written comments. These substantive discussions have been reduced to writing and placed in the public rulemaking file.

B. Specific Comments and Responses on the Proposal to Reduce the Lending Limit from 25 Percent to 15 Percent

1. Agreement with the Proposal

A few commenters agreed with the proposal to reduce the lending limit from 25 percent to 15 percent. One commenter also indicated that it does not anticipate that the lower limit will negatively affect its current lending and leasing practices.

In addition, one commenter recommended that there be consistent limits for titles I and II lenders as well as for title III lenders. This commenter explained that titles I and II lenders also provide financing for cooperatives and would be at a competitive disadvantage with CoBank, ACB (CoBank), the only title III lender in the System. While it is true that associations provide some financing directly to cooperatives, the overwhelming majority of lending to cooperatives by titles I and II lenders is made through CoBank. We fully support continuation of these risk-sharing arrangements, and believe that risk sharing among associations and their funding banks and/or CoBank will enable associations to continue to meet the credit needs of cooperatives, which choose to do business through their local association. We do not believe the 15-percent lending limit will change this business landscape, nor create a competitive disadvantage for titles I and II lenders. Further, as stated in the preamble to the proposed rule, we chose not to address the title III lending limits in this rulemaking due to the complexity of the issues and indicated that, should we decide to address title III lending limits in the future through a regulation amendment, we would do so in a separate rulemaking.

2. No Need to Lower the Limit

A few commenters questioned the need to lower the lending limit, stating that a lower limit was not the best solution to address unsafe lending practices. Rather than lower the limit for those institutions with a positive track record, these commenters advised the Agency to address the few problem institutions individually.

We believe that lowering the lending limit is an effective way to ensure that System institutions' lending practices do not result in unsafe concentrations of risk. Moreover, as stated in the proposed rule, the significant growth in System capital since the lending limit was last set in the early 1990s provides the System with significant lending capacity. Accordingly, the current 25-percent limit is no longer considered necessary or prudent.

Further, as stated in the proposed rule, a majority of titles I and II lenders already have internal lending limits that are more aligned with the 15-percent limit the Agency is now imposing. Therefore, those System institutions with a positive track record should not find compliance with the 15-percent limit onerous. The Agency also believes that imposing such limits by regulation rather than on individual institutions best meets due process principles of fairness, consistency, and transparency, as well as providing an opportunity to be heard through the public comment process.

One commenter also stated that there was no need to lower the lending limits because its funding bank already enforces a 20-percent hold limit. The fact that System banks are enforcing limits below the current 25-percent limit evidences their recognition that the current limit is too high and provides additional support for the new limit of 15 percent.

One commenter questioned the need to lower the lending limit since risk may be mitigated using Farm Service Agency guarantees, farm program subsidies and crop insurance. We note that loans or portions of loans that have a Government guarantee, as well as loans fully secured by obligations fully guaranteed by the United States Government, are exempt from the computation of loans to one borrower under § 614.4358 of the lending limit regulation. Hence, the fact that a System institution may mitigate risk using such guarantees has no bearing on loans subject to the lending limit.

3. Impact on Competitiveness

One commenter indicated that lowering the lending limit to 15 percent would put System institutions at a competitive disadvantage with National banks, which may loan up to 15 percent plus an additional 10 percent if the loan is fully secured by readily marketable collateral such as livestock, dairy cattle and warehouse receipts. Similarly, this commenter indicated that System institutions would be at a competitive disadvantage with State-chartered banks because such banks also have higher lending limits.

The FCA has carefully considered whether the 15-percent limit would put System lenders at a competitive disadvantage with National and State-chartered banks and have concluded it will not for all of the following reasons. First, an overwhelming majority of titles I and II lenders currently have in-house lending limits of 20, 15 and even 10 percent. The 15-percent limit, therefore, should not have a significant impact on the competitive position of the majority of System institutions with regard to National and State banks. We also note that these self-imposed limits have not resulted in a reduction in the System's market share of agricultural lending -— a market share that has, in fact, grown over the last decade or so.

Second, our review of lending limit regulations for State-chartered banks indicates that such limits vary widely. However, like National banks, in most case loans with higher lending limits made by State-chartered banks must be fully secured by readily marketable collateral.

The FCA also considered, but did not adopt exceptions to the rule based on the type and quantity of collateral supporting the loan. The concern over the time and difficulty of administering such exceptions outweighed any potential benefits that might result for System borrowers. Furthermore, the FCA does not wish to encourage System institutions to place undue reliance upon collateral as a basis for extending credit above the 15-percent limit.

The Agency also believes that comparisons with National and State-chartered banks are of limited value given that the System as a single-industry agricultural lender, a cooperative and a Government-Sponsored Enterprise with public mission responsibilities, operates very differently in many respects from other Federal or State- chartered lending institutions. Given the unique and public purpose role of the System, the Agency has an obligation to ensure its safety and soundness so that the System remains a dependable and adequate source of credit to American farmers and ranchers. We also believe the 15-percent lending limit appropriately addresses the Agency's concerns over the volatility of agricultural lending as well as single-credit and industry concentrations. For all the foregoing reasons, we believe the 15-percent limit will enhance the overall strength of each System institution, thus leveraging the System's ability to compete even more successfully with National and State-chartered banks for a share of the agricultural credit market.

Another commenter stated that the lower limits would delay the loan approval process since more than one lending institution would be involved in a loan, further reducing an institution's competitiveness in the marketplace. FCA acknowledges that a longer loan approval process may result from risk-sharing agreements (i.e., participations, capital/asset pools, guarantees, etc.). However, we also believe that the additional due diligence performed by the other lenders in these risk-sharing agreements will lead to better credit decisions and a stronger loan portfolio in each System institution –- benefits that will far outweigh any inconveniences resulting from such agreements. Further, the delayed effective date of this rule will give System institutions time to forge new relationships with other institutions so that procedures can be in place for approving such loans without significant delay.

4. <u>Impact on Future Earnings</u>

One commenter asserted that the lower lending limit would cause a substantial reduction in future earnings because larger loans represent its association's best quality, least risky and most profitable segment of its loan portfolio.

While large loans may be of sound quality and profitable, such loans have a greater impact on the viability of an institution should they deteriorate. It is the Agency's belief that a diversified loan portfolio that serves all eligible borrowers, both large and small, is one of the best ways to ensure an institution's stability.

Further, earning streams need not suffer, nor should any potential loans be forced out of the System solely on the basis of this final regulation. Each System institution should use the time provided by the delayed effective date of this rule to develop risk-sharing agreements so it can continue to meet the needs of the borrowers in its territory.

Another commenter indicated that the lower lending limit would reduce earnings because an association would be forced to sell off high quality loans, resulting in a lower return on assets and equity along with a restricted ability to build capital. This commenter also believed that the lower limit would reduce net income, negatively affecting an association's efficiency performance as reflected in its gross and net operating rates and efficiency ratio.

Although a System institution may temporarily forego some earnings as a result of reducing the size of a loan it holds, any opportunity cost should be offset by its reduced exposure to concentration risk. Such concentration risk is a greater threat to the safety and soundness of a System institution than a temporary loss of earnings. In addition, lower concentration risk levels require less capital to buffer risk that may exist in a loan portfolio, thereby lowering the capital requirements of a System lender.

Finally, we note that all existing loans are grandfathered under the transition provisions of this regulation. Therefore, unless the terms of a loan are changed, rendering it a "new loan" under the rule that would need to comply with the 15-percent lending limit, System institutions will not be forced to sell off high quality loans. Further, the delayed effective date should give System institutions enough time to forge the necessary lending relationships to offset any anticipated negative income and performance results.

5. Effect on Patronage Distributions and Customer Service

Two commenters stated that the lower limits would result in a loss of patronage paid to borrowers because System institutions would be forced to sell more participations to lenders not paying patronage. One of these commenters asserted that a loss of patronage payments by an association would cause its borrowers to spread rumors about the financial troubles of the association, resulting in a negative image for the System throughout the community. One of these commenters also stated that the lower limit would unnecessarily hurt farmers and ranchers.

While one of the effects of the final regulation is expected to be the greater use of risk-sharing agreements, the FCA expects that those System institutions paying patronage will find like partners or, alternatively, partners that will agree to patronage. System lenders can use these risk-sharing agreements to manage risk while still receiving financial consideration in the form of patronage or loan fees from a loan sale. These agreements should mitigate any temporary impact from reducing the size of loan held by a lender, as the lender can still receive income without bearing the risk of loss from holding a larger portion of the loan principal or commitment.

We also believe that such risk-sharing activities will encourage additional market discipline in System institutions by requiring them to price loans appropriately in order to find willing lending partners. We believe that the added due diligence, diversity and market discipline that lending partners bring to a System institution's loan and patronage practices will strengthen System institutions, ensure their long-term safety and soundness and benefit, rather than hurt, the System's farmer and rancher borrowers.

6. Effect of Lower Limits on Smaller System Institutions

A few commenters stated that, while lower limits may be appropriate for larger System associations, they would cause hardships on smaller associations. These commenters were concerned that the lower lending limit would make it even more challenging for small associations to meet the capital demands of those borrowers with large farming and ranching operations. One commenter suggested that the Agency should consider making exceptions to the 15-percent limit for small associations or allowing the System funding banks to make such exceptions in their general financing agreements with their district associations. Alternatively, this commenter suggested allowing the funding banks to authorize an association's use of a higher lending limit, not to exceed 25 percent, subject to other credit factors such as the association's size and capital base.

The Agency is sensitive to the fact that the lower limit may initially be more of a burden on smaller System associations. In response to this concern, we are issuing this regulation with a delayed effective date of approximately 1 year to give all titles I and II lenders more time to establish participation, syndication, capital pooling or other risk-sharing agreements so that they may continue to serve the needs of the borrowers in their territories.

However, we also note, as stated in the preamble to the proposed regulation, that the substantial growth in the capital bases of titles I and II System institutions since the current lending limit was first promulgated, has given all System lenders, including the smaller ones, much greater capacity to meet the needs of large borrowers. It is also true that smaller System institutions are often more at risk from large loans that cease to perform since their capacity to absorb such losses is often not as great as in larger-sized institutions.

The FCA considered the commenters' suggestions for exceptions to the lending limit for smaller associations and also considered the following alternatives to address the issue:

- Establishing the lending limit at the greater of 15 percent or a specific dollar amount for smaller System institutions, or
- Permanently grandfathering existing loans (even when the terms of the loan change) held by smaller institutions with a higher lending limit percentage or based on a specified dollar amount.

We ultimately rejected all of these alternatives for several reasons, not the least of which is our continued belief that the 15-percent lending limit is necessary for the long-term safety and soundness of all System institutions, including and especially the smaller institutions. We also believe that making exceptions for smaller associations, either through the funding banks or by regulation, would be difficult to effectively administer and monitor, and could end up weakening rather than strengthening the smaller institutions. Finally, with the delayed effective date providing time for System institutions to establish additional risk-sharing agreements, we believe that all System institutions, including the smaller ones, will be able to continue to meet the mission of servicing the credit needs of the creditworthy, eligible borrowers in their respective territories.

Finally, one commenter stated that lowering the lending limit for the smallest System associations is not necessary because such institutions pose no risk to the System as a whole.

As the safety and soundness regulator, it is the FCA's duty to ensure the safe and sound operation of every System institution. It would be irresponsible for the Agency to ignore or permit an unsafe lending limit based on the notion that the System as a whole could absorb the insolvency of a small institution. Further, it is important to consider the disruption caused by the failure of an institution to its farmer and rancher borrowers, to the consequences on the institution's employees or members of the community, or to the fact that the continued viability of even the smallest System association is vital to achieving the mission of the System.

This same commenter indicated that the lower limit would reduce the System's diversity in business models, presumably by forcing the smaller associations to merge with larger associations. A reduction in the diversity of System business models does not necessarily accompany the further consolidation of the System. We believe that the most successful business models adapt to changes in the operating environment, which serves to strengthen the System.

Given the concern over the impact of the 15-percent lending limit on smaller associations, the Agency especially encourages each funding bank to carefully evaluate the lending limits imposed by its general financing agreements (GFA). It may be appropriate to maintain the GFA limit at the 15-percent level for smaller associations if the bank and associations determine that the 15-percent level is needed to adequately serve the needs of the borrowers in their respective territories. This analysis should be completed with regard to each particular association's lending capacity, history, expertise, etc., and the resulting risk to the funding bank.

7. Transition Period

One commenter indicated that the transition rule contained in § 614.4361 should be lengthened to allow System institutions sufficient time to develop risk-sharing agreements to conform new loans to the 15-percent lending limits without a loss of business or customers. The FCA agrees with the need to provide more time to System institutions to develop such agreements which is why, as mentioned earlier, this final rule is being issued with a delayed effective date, giving institutions approximately 1 year to comply with the rule's requirements.

Therefore, we are deleting proposed § 614.4361(c), which in the proposed rule would have given titles I and II System institutions 6 months from the effective date to comply with the new limits and would have given titles I, II and III System institutions 6 months from the effective date to comply with the new policy requirements.

C. Specific Comments and Responses on the Proposed Loan and Lease Concentration Risk Mitigation Policies

1. Agreement with the Proposal

Two commenters agreed with the requirement to adopt risk mitigation policies and recognized the need for all financial institutions to adhere to such policies. However, one of these commenters added that such policies will not, in and of themselves, protect the System without corresponding efforts from associations to responsibly manage portfolio risk. The FCA agrees with these comments and encourages each title I, II and III System institution's board of directors to adopt robust internal controls, such as reporting requirements and other accountability safeguards, so that the board remains engaged in ensuring that those policy authorities delegated to management are effectively carried out.

2. Need for the Regulation

One commenter indicated that it did not believe that the FCA has to change its regulations to require associations to set prudent lending limits.

The FCA believes that a regulation requiring a written risk mitigation policy is necessary since our current regulations do not impose lending limits based on specified risks in an institution's loan portfolio and practices. The policy required by this final rule focuses on the mitigation of risks caused by undue industry concentrations, counterparty risks, ineffective credit administration, inadequate due diligence practices, or other shortcomings that could be present in a System institution's lending practices. The recent stresses experienced by System institutions caused by downturns in the poultry, ethanol, hog and dairy industries underscore the need for such policies in System institutions.

This commenter also indicated that the FCA has sufficient enforcement powers to ensure safe and sound loan portfolio risk mitigation by System institutions and also reminded the FCA of Congress' previous instruction to eliminate all regulations that "are unnecessary, unduly burdensome or costly."

The risk mitigation policy required by this rule is intended to strengthen a System institution's loan portfolio so that it can better withstand stresses experienced by a single borrower, industry sector or counterparty. The policy must set forth sound loan and lease concentration risk mitigation practices in order to *prevent* weak and unsound practices. In contrast, our enforcement authorities apply when a System institution (or other persons) engages, has engaged, or is about to engage in an unsafe or unsound practice in conducting the business of the institution. In addition, this commenter stated that the lower lending limits do not justify the need to regulate the specific content of an institution's lending policies, asserting that FCA's existing loan policy regulation at § 614.4150 already establishes the necessary regulatory framework for lending standards. In lieu of the regulations proposed by the FCA, this commenter suggests simply adding the phrase "effectively measure, limit and monitor exposures to concentration risk" to existing § 614.4150.

Section 614.4150 addresses requirements for prudent credit extension practices and underwriting standards for individual loans, but falls short of addressing concentration risks inherent in an institution's loan portfolio. Although some institutions have already established policies to address loan concentration risks, many have not. This final regulation is necessary to ensure that all System institutions adopt adequate risk mitigation policies. System institutions are free, however, to incorporate the requirements of this policy into their already existing lending policies.

For all the foregoing reasons, we believe that the establishment of a policy to mitigate loan concentration risks is necessary and will not be unduly burdensome or costly to System institutions.

3. Lack of Specificity in the Requirements for a Loan and Lease Concentration Risk Mitigation Policy

A few commenters thought that the risk mitigation policy was too vague, the risks mentioned would be too difficult to quantify, and the policy would not make the System safer, noting specifically that:

- The quantitative method(s) are not sufficiently defined and may unnecessarily limit the flexibility of System institutions seeking to facilitate credit opportunities for eligible and qualified System borrowers;
- Certain System institutions serve areas where particular agricultural industries dominate in their territories, resulting in unavoidable loan concentrations in their loan portfolios;
- Risks emanating from unique factors, such as dependence on off-farm income from a local manufacturing plant are difficult to effectively identify, measure, limit and monitor and are not susceptible to meaningful quantitative measures. Attempts to measure such risks could lead to arbitrary decisions that contradict the System's mission of making credit available to qualified farmers;
- The requirements of the policy could prevent System institutions from making loans to producers with a limited market for their farm products;
- The imposition of specific policy elements and quantitative methods is not appropriate for a regulation since each institution's territory, nature and scope of its activities and risk-bearing capacity is unique;
- The regulation provides no definition of the meaning of a "single-industry sector" so it is

unclear how broadly or narrowly this phrase should be defined;

- It is neither practical, necessary, or realistic to create a meaningful quantitative method around what may be a limitless set of risk factors; and finally,
- The policy would not enhance the underlying safety and soundness of the System.

The FCA recognizes that there is no ideal uniform approach to a loan and lease concentration risk mitigation policy. For this reason, the regulation intentionally outlines only minimally required elements. It is up to each institution, based on the unique risks in its territory and risk-bearing capacity, to identify and define concentration risks so that they can be effectively mitigated. For these reasons, the regulation gives institutions wide latitude to define terms, such as "industry sectors" according to their best business judgment and based on the familiarity with the types of agriculture in their territories.

For those commenters expressing apprehension about which risk factors to identify, we have added language to the rule clarifying that quantitative methods need be established only for ***significant*** concentration risks that are ***reasonably*** foreseeable. We leave it to the discretion of each institution, using their experience in providing agricultural credit and their best business judgment, to determine which credit concentration risks are significant – that is, which risks have the most potential to lead to serious loss.

The discretion the rule gives to System institutions is intended to ensure that institutions adequately control risk without limiting their ability to continue being a steady source of credit to all eligible and creditworthy borrowers in their respective territories. The policy should not result in System institutions having to make arbitrary credit decisions or turn away qualified borrowers. Rather, the policy requires institutions to mitigate rather than deny those loan concentrations presenting significant and reasonably foreseeable risks. Concentration risks caused, for example, by territories with producers/borrowers that have limited agricultural markets or few agricultural sectors may be mitigated through one or more of the following options, including hold limits, an increase in capital, loss-sharing agreements or other risk mitigation tools.

Consistent with the language in the preamble to the proposed regulations, we have deleted the reference to direct lender from the regulation text to make clear that the loan and lease concentration risk mitigation policy requirements also apply to title III System institutions.

4. Period for Adopting the New Loan and Lease Concentration Risk Mitigation Policy

One commenter encouraged the FCA to carefully consider the difficulty System institutions are likely to have in implementing the proposed changes. This commenter also indicated that the 6-month period for adopting the risk mitigation policy would not provide sufficient time for System boards of directors to properly evaluate and adopt policies to address those concentrations in their current portfolios that are not currently measured. As discussed in detail above, the final regulation is being issued with a delayed effective date, giving all System institutions approximately a 1-year period to adopt such policies.

IV. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FCA hereby certifies that the final rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, Farm Credit System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

List of Subjects in 12 CFR Part 614

Agriculture, Banks, banking, Foreign trade, Reporting and recordkeeping requirements, Rural areas.

For the reasons stated in the preamble, part 614 of chapter VI, title 12 of the Code of Federal Regulations is amended as follows:

PART 614--LOAN POLICIES AND OPERATIONS

1. The authority citation for part 614 continues to read as follows:

Authority: 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128; secs. 1.3, 1.5, 1.6, 1.7, 1.9, 1.10, 1.11, 2.0, 2.2, 2.3, 2.4, 2.10, 2.12, 2.13, 2.15, 3.0, 3.1, 3.3, 3.7, 3.8, 3.10, 3.20, 3.28, 4.12, 4.12A, 4.13B, 4.14, 4.14A, 4.14C, 4.14D, 4.14E, 4.18, 4.18A, 4.19, 4.25, 4.26, 4.27, 4.28, 4.36, 4.37, 5.9, 5.10, 5.17, 7.0, 7.2, 7.6, 7.8, 7.12, 7.13, 8.0, 8.5 of the Farm Credit Act (12 U.S.C. 2011, 2013, 2014, 2015, 2017, 2018, 2019, 2071, 2073, 2074, 2075, 2091, 2093, 2094, 2097, 2121, 2122, 2124, 2128, 2129, 2131, 2141, 2149, 2183, 2184, 2201, 2202, 2202a, 2202c, 2202d, 2202e, 2206, 2206a, 2207, 2211, 2212, 2213, 2214, 2219a, 2219b, 2243, 2244, 2252, 2279a, 2279a-2, 2279b, 2279c-1, 2279f, 2279f-1, 2279aa, 2279aa-5); sec. 413 of Pub. L. 100-233, 101 Stat. 1568, 1639.

Subpart J--Lending and Leasing Limits

§ 614.4352 [Amended]

2. Section 614.4352 is amended by:

a. Removing the comma after the word "borrower" and removing the number "25" and adding in its place, the number "15" in paragraph (a);

b. Removing the comma after the word "Act" and removing "exceeds 25" and adding in its place "exceed 15" in paragraph (b)(1); and

c. Removing the comma after the word "Act" and removing "exceeds" and adding in its place "exceed" in paragraph (b)(2).

§ 614.4353 [Amended]

3. Section 614.4353 is amended by:

a. Adding the words "direct lender" after the word "No";

b. Removing the comma after the word "borrower"; and

c. Removing "exceeds 25" and adding in its place "exceed 15".

§ 614.4354 [Removed]

4. Section 614.4354 is removed.

§ 614.4356 [Amended]

5. Section 614.4356 is amended by removing the number "25" and adding in its place, the number "15".

6. Section 614.4362 is added to subpart J to read as follows:

§ 614.4362 <u>Loan and lease concentration risk mitigation policy</u>.

The board of directors of each title I, II, and III System institution must adopt and ensure implementation of a written policy to effectively measure, limit and monitor exposures to concentration risks resulting from the institution's lending and leasing activities.

(a) *<u>Policy elements</u>.*

The policy must include:

(1) A purpose and objective;

(2) Clearly defined and consistently used terms;

(3) Quantitative methods to measure and limit identified exposures to significant and reasonably foreseeable loan and lease concentration risks (as set forth in paragraph (b) of this section); and

(4) Internal controls that delineate authorities delegated to management, authorities retained by the board, and a process for addressing exceptions and reporting requirements.

(b) *<u>Quantitative methods</u>.*

(1) At a minimum, the quantitative methods included in the policy must measure and limit identified exposures to significant and reasonably foreseeable concentration risks emanating from:

(i) A single borrower;

(ii) A single-industry sector;

(iii) A single counterparty; or

(iv) Other lending activities unique to the institution because of its territory, the nature and scope of its activities and its risk-bearing capacity.

(2) In determining concentration limits, the policy must consider other risk factors that could identify significant and reasonably foreseeable loan and lease losses. Such risk factors could include borrower risk ratings, the institution's relationship with the borrower, the borrower's knowledge and experience, loan structure and purpose, type or location of collateral (including loss given default ratings), loans to emerging industries or industries outside of an institution's area of expertise, out-of-territory loans, counterparties, or weaknesses in due diligence practices.

Dated: May 19, 2011

Dale L. Aultman,
<u>Secretary</u>,
<u>Farm Credit Administration Board</u>.

72 FR 61568, 10/31/2007

Handbook Mailing HM-07-8

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AC25

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Capital Adequacy--Basel Accord

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking (ANPRM).

SUMMARY: The Farm Credit Administration (FCA or we) is considering possible modifications to our risk-based capital rules for Farm Credit System institutions (FCS or System) that are similar to the standardized approach delineated in the New Basel Capital Accord. We are seeking comments to facilitate the development of a proposed rule that would enhance our regulatory capital framework and more closely align minimum capital requirements with risks taken by System institutions. We are also withdrawing our previously published ANPRM.

DATES: You may send comments on or before March 31, 2008.

ADDRESSES: We offer several methods for the public to submit comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the Agency's Web site or the Federal eRulemaking Portal. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- Agency Web site: http://www.fca.gov. Select "Legal Info," then "Pending Regulations and Notices."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.
- FAX: (703) 883-4477. Posting and processing of faxes may be delayed, as faxes are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act. Please consider another means to comment, if possible.

You may review copies of comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select “Legal Info,” and then select “Public Comments.” We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Laurie Rea, Associate Director, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4232, TTY (703) 883-4434,

or

Wade Wynn, Policy Analyst, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4262, TTY (703) 883-4434,

or

Rebecca S. Orlich, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objectives

The objective of this ANPRM is to gather information to facilitate the development of a comprehensive proposal that would:

1. Promote safe and sound banking practices and a prudent level of regulatory capital for System institutions;[1]

2. Improve the risk sensitivity of our regulatory capital requirements while avoiding undue regulatory burden;

3. To the extent appropriate, minimize differences in regulatory capital requirements between System institutions and federally regulated banking organizations;[2] and

4. Foster economic growth in agriculture and rural America through the effective allocation of System capital.

In addition, we are withdrawing our previous ANPRM on capital, published in the Federal Register on June 21, 2007 (72 FR 34191), as described more fully below.

II. Background

The FCA’s risk-based capital requirements for System institutions are contained in subparts H and K of part 615 of our regulations.[3] Our risk-based capital framework is based, in part, on the “International Convergence of Capital Measurement and Capital Standards” (Basel I) as published by the

Basel Committee on Banking Supervision (Basel Committee)[4] and is broadly consistent with the capital requirements of the other Federal financial regulatory agencies.[5] We first adopted a risk-based capital framework for the System as part of our 1988 regulatory capital revisions[6] required by the Agricultural Credit Act of 1987[7] and made subsequent revisions in 1997,[8] 1998[9] and 2005.[10] Under the current capital framework, each on- and off-balance sheet credit exposure is assigned to one of five broad risk-weighting categories to determine the risk-adjusted asset base, which is the denominator for computing the permanent capital, total surplus, and core surplus ratios.

For a number of years, the Basel Committee has worked to develop a more risk sensitive regulatory capital framework that incorporates recent innovations in the financial services industry. In June 2004, it published the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Basel II) to promote improved risk measurement and management processes and more closely align capital requirements with risk.[11] Basel II has three pillars: 1) Minimum capital requirements for credit risk, operational risk, and market risk, 2) supervision of capital adequacy, and 3) market discipline through enhanced public disclosure. Banking organizations have various options for calculating the minimum capital requirements for credit and operational risk. For credit risk, the options are the standardized approach, the foundation internal ratings-based approach, and the advanced internal ratings-based approach (A-IRB). For operational risk, the options are the basic indicator approach, the standardized approach, and the advanced measurement approach (AMA).

In September 2006, the other Federal financial regulatory agencies issued an interagency notice of proposed rulemaking for implementing the advanced approaches of Basel II in the United States (the advanced capital framework).[12] This advanced capital framework would require core banks[13] and permit opt-in banks[14] to use the A-IRB[15] to calculate the regulatory capital requirement for credit risk and the AMA[16] to calculate the regulatory capital requirement for operational risk.[17]

Given the small number of core banks and the complexity and cost associated with voluntarily adopting the advanced approaches, only a small number of U.S. banking organizations are expected to implement the advanced capital framework. As a result, a bifurcated regulatory capital framework will be created in the United States, which could result in different regulatory capital charges for similar products offered by those that apply the advanced capital framework and those that do not. Financial regulators, banking organizations, trade associations and other interested parties have raised concerns that the bifurcated structure could create a significant competitive disadvantage for those that do not apply the advanced capital framework.

In December 2006, the other Federal financial regulatory agencies addressed these concerns by issuing an interagency notice of proposed rulemaking (Basel IA) to improve the risk sensitivity of the existing Basel I-based capital framework.[18] Subsequently, the FCA issued an ANPRM,[19] published in June 2007, addressing issues similar to those addressed in Basel IA. Basel IA was intended to help minimize the potential differences in the regulatory minimum capital requirements of those banks applying the advanced capital framework and those banks that would not. The other Federal financial regulatory agencies received a significant number of comments opposing their Basel IA proposal. Many commenters argued that the benefits of complying with Basel IA did not outweigh the burdens, and many questioned why the U.S. banking agencies were creating a separate rule that had only minor differences from the standardized approach under Basel II. On July 20, 2007, the other Federal financial regulatory agencies announced that they intended to replace the Basel IA proposal with a proposed rule that would provide all non-core banks the option to adopt the standardized approach under Basel II.[20] Their stated intent is to finalize a standardized approach for banks that do not adopt the advanced approaches before the core (and opt-in) banks begin their first transition period year under the advanced approaches of Basel

II.

The other Federal financial regulatory agencies plan to replace Basel IA with a proposed rule patterned after the standardized approach under Basel II. Consequently, we are withdrawing our previous ANPRM and replacing it with one that is also consistent with the standardized approach. We intend to develop a proposed rule that is similar to the capital requirements of the other Federal financial regulatory agencies where appropriate but also tailored to fit the System's distinct borrower-owned lending cooperative structure and Government-sponsored enterprise (GSE) mission.

The questions posed in this ANPRM are, for the most part, similar to the questions we asked in our previous ANPRM.[21] We have revised the technical material in most places to conform to the standardized approach of Basel II. For example, we replaced the risk-weight categories that were in the Basel IA proposed rule with the risk-weight categories that are contained in the standardized approach under Basel II. We ask commenters to consider the revised material when answering the following questions. We seek comments from all interested parties to help us develop a comprehensive proposal that would enhance our regulatory capital framework and increase the risk sensitivity of our risk-based capital rules without unduly increasing regulatory burden.

III. Questions

When addressing the following questions, we ask commenters to consider the overarching objectives of Basel II to more closely align capital with the specific risks taken by the financial institution rather than relying on a "one-size-fits-all" approach for determining regulatory minimum risk-based capital requirements. Our objective is to develop a more dynamic risk-based capital framework that is more sensitive to the relative risks inherent in System lending and other mission-related activities. We seek comments on specific criteria that might be used to determine appropriate risk weights that meet this objective without creating undue burden. Specifically, we ask that you support your comments with data, to the extent possible, in response to our questions.[22]

A. Increase the Number of Risk-Weight Categories

Our existing risk-based capital rules assign exposures to one of five risk-weight categories: 0, 20, 50, 100, and 200 percent.[23] The standardized approach of Basel II adds risk-weight categories of 35, 75, and 150 percent and replaces the 200-percent risk-weight category with a 350-percent risk-weight category.[24] The 35-percent risk-weight category would apply to certain residential mortgages. The 75-percent risk-weight category would apply to certain retail claims (e.g., small business loans). The 150-percent and 350-percent risk-weight categories would apply to certain higher risk externally rated exposures (e.g., those below investment grade).

Question 1: We seek comment on what additional risk-weight categories, if any, we should consider for assigning risk weights to System institutions' on- and off-balance sheet exposures. If additional risk-weight categories are added, what assets should be included in each new risk-weight category?

B. Use of External Credit Ratings to Assign Risk-Weight Exposures

1. Direct Exposures

In recent years, the FCA has permitted System institutions to use external ratings to assign risk weights to certain credit exposures linked to nationally recognized statistical rating organizations (NRSROs) ratings.[25] For example, in March 2003, we adopted an interim final rule that permitted System institutions to use NRSRO ratings to place highly rated investments in non-agency asset-backed securities (ABS) and mortgage-backed securities (MBS) in the 20-percent risk-weight category.[26] In April 2004, we expanded the use of NRSRO ratings to assign risk weights to loans to other financing institutions.[27] In June 2005, we adopted a ratings-based approach to assign risk weights to recourse obligations, direct credit substitutes (DCS), residual interests (other than credit-enhancing interest-only strips), and other ABS and MBS investments.[28] Furthermore, we recently permitted the use of NRSRO ratings to assign risk weights to certain electric cooperative credit exposures.[29]

The standardized approach of Basel II expands the use of NRSRO ratings to determine the risk-based capital charge for long-term exposures to sovereign entities, non-central government public sector entities (PSEs), banks[30], corporate entities, and securitizations as displayed in Table 1 set forth below.[31]

Table 1 – The Standardized Approach Risk Weights Based on External Ratings for Long-Term Exposures

Credit Assessment	Sovereign Risk Weight (in percent)	PSE and Bank* Risk Weights (in percent)		Corporate Risk Weight (in percent)	Securitization**Risk Weight (in percent)
		Option 1	Option 2		
AAA to AA-	0	20	20	20	20
A+ to A-	20	50	50	50	50
BBB+ to BBB-	50	100	50	100	100
BB+ to BB-	100	100	100	100	350
B+ to B-	100	100	100	150	Deduction ***
Below B-	150	150	150	150	Deduction ***
Unrated	100	100	50	100	Deduction ***

* The Standardized Approach provides two options for PSEs and bank exposures: (1) Option 1 assigns a risk weight one category below that of sovereigns; (2) Option 2 assigns a risk weight based on the individual bank rating. Option 2 also provides risk weights for short-term claims as follows: (1) AAA to BBB- and unrated = 20 percent; (2) BB+ to B- = 50 percent; and (3) Below B- = 150 percent.

** Short-term rating categories are as follows: (1) A-1/P-1 = 20 percent; (2) A-2/P-2 = 50 percent; (3) A-3/P-3 = 100 percent; and (4) All other ratings or unrated = Deduction.

*** Banks must deduct the entire amount from capital. However, if banks originate a securitization and the most senior exposure is unrated, the bank may use the "look through" treatment, which is the average risk weight of the underlying exposures subject to supervisory review.

System institutions provide financing to agriculture and rural America through a variety of lending[32] and investment[33] products. They also hold highly rated liquid investments to manage liquidity, short-term surplus funds, and interest rate risk. Our existing risk-based capital rules assign most agricultural and rural business[34] loans and mission-related investment assets to the 100-percent risk-weight category unless the risk exposure is mitigated by an acceptable guarantee or collateral. The FCA is considering the expanded use of NRSRO ratings to assign risk weights to other externally rated credit exposures in the System, such as corporate debt securities and loans.

Question 2: We seek comments on all aspects of the appropriateness of using NRSRO ratings to assign risk weights to credit exposures. If we expand the use of external ratings, how should we align the risk-weight categories with NRSRO ratings to determine the appropriate capital charge for externally rated credit exposures? Should any externally rated positions be excluded from this new ratings-based approach? We ask commenters to consider the substantial reliance on NRSRO ratings as a means of evaluating the quality of debt investments in view of recent events in the subprime mortgage market.

2. <u>Recognized Financial Collateral</u>

Our current risk-based capital rules assign lower risk weights to exposures collateralized by: (1) Cash held by a System institution or its funding bank; (2) securities issued or guaranteed by the U.S. Government, its agencies or Government-sponsored agencies; (3) securities issued or guaranteed by central governments in other OECD[35] countries; (4) securities issued by certain multilateral lending or regional development institutions; or (5) securities issued by qualifying securities firms.

The standardized approach of Basel II has two methods for recognizing a wider variety of collateral types for risk-weighting purposes.[36] Under the simple approach, the collateralized portion of the exposure would be assigned a risk weight (as listed in Table 1) according to the external rating of the collateral. The remainder of the exposure would be assigned a risk weight appropriate to the counterparty. Collateral would be subject to a 20-percent floor unless the collateral is cash, certain government securities or repurchase agreements, and it would be marked-to-market and revalued every 6 months. Securities issued by sovereigns or PSEs must be rated at least BB- or its equivalent by a NRSRO. Securities issued by other entities must be rated at least BBB- or its equivalent by an NRSRO. Short-term debt instruments used as collateral must be rated at least A-3/P-3 or its equivalent by an NRSRO.

Under the comprehensive approach, the banking organization adjusts the value of the exposure by the discounted value of the collateral. Discount values, known as supervisory haircuts, are displayed in Table 2 set forth below. For example, sovereign debt rated A+ with a 5-year maturity used as collateral is discounted by 3 percent, and corporate debt rated A+ with a 5-year maturity is discounted at 6 percent.

Table 2 – Standard Supervisory Haircuts in the Comprehensive Approach for Credit Mitigation

Issue rating for debt securities	Residual maturity	Sovereigns and PSEs* (in percent)	Other issuers** (in percent)
AAA to AA- or A-	≤ 1 year	0.5	1
	> 1 year, ≤ 5 years	2	4
	> 5 years	4	8
A+ to BBB- or A-2/A-3/P-3	≤ 1 year	1	2
	> 1 year, ≤ 5 years	3	6
	> 5 years	6	12
BB+ to BB-	All	15	

* Includes PSEs treated as sovereigns
** Includes PSEs not treated as sovereigns

Question 3: We seek comment on whether recognizing additional types of eligible collateral would improve the risk sensitivity of our risk-based capital rules without being overly burdensome. We also seek comment on what additional types of collateral, if any, we should consider and what effect the collateral should have on the risk weighting of System exposures.

3. Eligible Guarantors

Our existing capital rules permit the use of third party guarantees to lower the risk weight of certain exposures. Guarantors include: (1) The U.S. Government, its agencies or Government-sponsored agencies; (2) U.S. state and local governments; (3) central governments and banks in OECD countries; (4) central governments in non-OECD countries (local currency exposures only); (5) banks in non-OECD countries (short-term claims only); (6) certain multilateral lending and regional development institutions; and (7) qualifying securities firms.

The standardized approach of Basel II expands the range of eligible guarantors to include sovereign entities, PSEs, banks and securities firms that have a lower risk weight than the counterparty.[37] All other guarantors must be rated A- (or its equivalent) or better by a NRSRO. The guarantee must: (1) Represent a direct claim on the protection provider, (2) be explicitly referenced to specific exposures or pools of exposures, (3) be irrevocable, and (4) unconditional. The guarantor's risk weight would be substituted for the risk weight assigned to the exposure. Non-guaranteed portions of the exposure would be assigned to the external rating of the exposure.

Question 4: We seek comment on what additional types of third party guarantees, if any, we should recognize and what effect such guarantees should have on the risk weighting of System exposures.

C. Direct Loans to System Associations

The FCA is considering ways to better align our risk-based capital requirements for direct loans with System associations. System banks make direct loans to their affiliated associations who, in turn, make retail loans to eligible borrowers. Our current risk-based capital rules assign a 20-percent risk weight to direct loans at the bank level and another risk weight (depending upon the type of loan) to retail loans at the association level.[38] The 20-percent risk weight is intended to recognize the risks to the banks associated with lending to their affiliated associations. We are exploring methods to improve the risk sensitivity of our risk-based capital rules by assigning different risk weights to direct loan exposures based on the System association's distinct risk profile.

Question 5: We seek comment on what evaluative criteria or methods we should use to assign risk weights to direct loans to System associations. How should the criteria be used to adjust the risk weight as the quality of the direct loan changes over time?

D. Small Agricultural and Rural Business Loans

Our existing risk-based capital rules assign small agricultural and rural business loans to the 100-percent risk-weight category unless the credit risk is mitigated by an acceptable guarantee or acceptable collateral. The standardized approach of Basel II applies a 75-percent risk weight to certain retail claims[39] provided: (1) The exposure is to an individual person or persons or to a small business, (2) the exposure is in the form of a revolving credit, line of credit, personal term loan or lease, or small business facility or commitment, (3) the regulatory supervisor is satisfied that the retail portfolio is sufficiently diversified to warrant such a risk weight, and (4) the total credit exposure to the borrower does not exceed approximately $1.4 million.[40]

Question 6: We seek comment on what approaches we should use to improve the risk sensitivity of our risk-based capital rules for small agricultural and rural business loans. More specifically, what criteria should we use to classify an agricultural or rural business as a small business? What criteria should we use to assign risk-weights of less than 100 percent to these types of loans?

E. Loans Secured by Liens on Real Estate

The FCA is considering ways to use loan-to-value ratios (LTV) and other criteria to determine the risk-based capital charges for farm real estate and qualified residential loans. Our existing capital rules assign farm real estate loans to the 100-percent risk-weight category and qualified residential loans[41] to the 50-percent risk-weight category. The standardized approach of Basel II assigns a 35-percent risk weight to all prudently underwritten residential mortgages. Basel IA had proposed to risk-weight loans secured by first and second liens on residential real estate based on LTV. We continue to believe that LTV is a viable option for determining appropriate risk-weights for farm real estate and qualified residential loans. We are also considering approaches that would combine borrower creditworthiness and other loan characteristics in conjunction with LTV.

Question 7: We seek comment on all aspects of using LTV to determine the appropriate risk-weight for farm real estate, qualified residential loans, or any other asset class. We also welcome comments on other methods that could be used to improve the risk sensitivity of our risk-based capital rules for these types of loans.

F. Loans 90 Days or More Past Due or in Nonaccrual[42]

Our existing risk-based capital rules assign most loans to the 100-percent risk-weight category unless the credit risk is mitigated by an acceptable guarantee or collateral. When exposures reach 90 days or more past due or are in nonaccrual status, there is a higher probability that the financial institution might incur a loss. The standardized approach of Basel II addresses this potentially higher risk of loss by assigning the unsecured portion of a loan that is 90 days or more past due (net of specific provisions) as follows:

- 150-percent risk weight when specific provisions are less than 20 percent of the outstanding amount of the loan;
- 100-percent risk weight when specific provisions are 20 percent or more of the outstanding amount of the loan;
- When specific provisions are 50 percent or more of the outstanding amount of the loan, the supervisor has the discretion to reduce the risk weight to 50 percent.

Question 8: We seek comment on all aspects related to risk-weighting exposures that reach 90 days or more past due or are in nonaccrual status.

G. Short- and Long-Term Commitments

Under § 615.5212, off-balance sheet commitments are generally risk-weighted in two steps: (1) The off-balance sheet commitment is multiplied by a credit conversion factor (CCF)[43] to determine its on-balance sheet credit equivalent; and (2) the on-balance sheet credit equivalent is assigned to the appropriate risk-weight category in § 615.5211 according to the obligor, after considering any applicable collateral and guarantees.[44] The standardized approach of Basel II assigns a 0-percent CCF to unconditionally cancelable commitments,[45] a 20-percent CCF to short-term commitments, and a 50-percent CCF to long-term commitments.[46]

Question 9: We seek comment on what approaches we should use to risk weight short- and long-term commitments that are not unconditionally cancelable.

H. Adjusting Risk Weights on Exposures over Time

The FCA welcomes comment on additional approaches or criteria that might be used to adjust the risk weight of exposures throughout the life of the asset. Our existing risk-based capital rules assign a static risk weight to assets within a given asset class without providing for risk-weight adjustments as asset quality improves or deteriorates. For example, most loans to System borrowers are risk-weighted at 100 percent throughout the life of the loan without making risk-weight adjustments based on credit classifications or other credit performance factors.

Question 10: We seek comment on what methods we should use to adjust the risk weight of credit exposures as the asset quality or default probability changes over time.

I. Capital Charge for Operational Risk

The FCA welcomes comments on possible approaches for determining a capital charge for operational risk. The broad risk-weighting categories under our existing capital rules are primarily designed to protect against credit or counterparty risk. As we move toward a more risk-sensitive capital framework, it may be appropriate to apply an explicit capital charge for operational risk, especially to cover risks associated with off-balance sheet activity.

Basel II defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people, systems, or from external events. This definition includes legal risk but excludes strategic and reputational risk. As previously mentioned, Basel II has three methods for applying a capital charge for operational risk. Under the basic indicator approach, the operational capital charge is equal to 15 percent of the 3-year average of positive annual gross income. Under the standardized approach, the operational capital charge is equal to the sum of a fixed percentage of the 3-year average of the gross income of eight business lines.[47] Under the AMA, the operational capital charge is derived from a bank's internal operational risk management systems and processes.

Question 11: We seek comment on what approach we should consider, if any, in determining a risk-based capital charge for operational risk.

J. Disclosure[48]

The FCA recognizes that market discipline contributes to a safe and sound banking environment and enhances risk management practices. Pillar III of Basel II is designed to complement the minimum capital requirements and supervisory review process by encouraging market discipline through meaningful public disclosure. The disclosure requirements are intended to allow market participants to assess key information about an institution's risk profile and associated level of capital to better evaluate risk management performance, earnings potential and financial strength.

Pillar III of Basel II presents the following general disclosure requirements: 1) Banks should have a formal disclosure policy approved by the board of directors that addresses the institution's approach for

determining the disclosures it should make;[49] 2) banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency of them; 3) banks should decide which disclosures are relevant based on the materiality concept;[50] and 4) the disclosures should be made on a semi-annual basis, subject to certain exceptions.[51]
The other Federal financial regulatory agencies have proposed the following additional requirements in the advanced capital framework: 1) The disclosures would follow U.S. generally accepted accounting principles, SEC mandates, and existing regulatory reporting requirements; 2) the banks would be required to disclose quantitative information on a quarterly basis following SEC deadlines; 3) the disclosures would be made publicly available (for example, on a Web site) for each of the last 3 years (that is, 12 quarters);[52] 4) disclosure of key financial ratios must be provided in the footnotes to the year-end audited financial statements;[53] 5) the chief financial officer must certify that the disclosures are appropriate; and 6) the board of directors and senior management are responsible for establishing the internal control structure over financial reporting.

Question 12: We seek comment on all aspects of the Basel II public disclosure requirements. Specifically, how would the System apply the public disclosure requirements of Pillar III given its unique cooperative structure?

K. Capital Leverage Ratio

We are considering whether we should supplement our existing risk-based capital rules with a minimum capital leverage ratio requirement for all FCS institutions to further promote the safety and soundness of the System. Our existing capital regulations require System banks to maintain a minimum net collateral ratio (NCR)[54] of 103 percent[55] but do not impose a capital leverage ratio on System associations. The NCR provides a level of protection for operating and other forms of risk at System banks, but it does not differentiate higher quality from lower quality capital. The other Federal financial regulatory agencies currently supplement their risk-based capital rules with a leverage ratio of Tier 1 capital to total assets (Tier 1 leverage ratio).[56] The Tier 1 leverage ratio consists of only the most reliable and permanent forms of capital such as common stock, non-cumulative perpetual preferred stock, and retained earnings.

Question 13: We seek comment on whether our capital rules should include a minimum capital leverage ratio requirement for all System institutions. We also seek comment on changes, if any, that should be made to the existing regulatory minimum NCR requirement applicable to System banks that would make it more comparable to the Tier 1 ratio used by the other Federal financial regulatory agencies.

L. Regulatory Capital Directives[57]

We are considering whether we should modify our capital rules to specify potential early intervention criteria for the issuance of capital directives. Currently, FCA has the discretion to issue a capital directive[58] when an institution's capital is insufficient. The FCA, however, has not defined capital or other financial early intervention thresholds to require an institution to take corrective action as described in § 615.5355. Early intervention approaches have been used in other contexts, including the System's Market Access Agreement and the statutory requirements applicable to other regulated financial institutions.[59] An early intervention capital directive framework could provide a clearer indication of when we would impose additional and increasing supervisory oversight on an institution to address continuing deterioration in its financial condition and capital position from credit, interest rate, or other financial risks.

Question 14: We seek comment on revising our current capital directive regulations to include an early intervention framework. We also seek comment on potential financial thresholds, such as capital ratios or risk measures, that would trigger an FCA capital directive action.

M. Multi-Dimensional Regulatory Structure

As stated above, one of FCA's objectives is to implement a revised capital framework that improves the risk sensitivity of our capital rules while avoiding undue regulatory burden. There are currently five banks and 95 associations in the System with varying degrees of asset size, complexity of operations, and sophistication in their risk management practices. Some System institutions have the risk management capabilities to apply more complex, risk-sensitive regulatory capital requirements than other System institutions. It may be appropriate for the FCA to adopt more than one set of capital rules to account for these differences. However, this approach could result in different capital requirements for the same type of transaction and increase examination and oversight costs.

As described above, the other Federal financial regulatory agencies are in the process of proposing two sets of capital rules for the financial institutions they regulate. The implementation of the advanced capital framework would be limited, for the most part, to the largest, internationally active banks that meet certain infrastructure requirements. Other banks would implement a simpler capital framework patterned after the standardized approach of Basel II.
While our expectation is to implement a revised capital framework similar to the standardized approach of Basel II, we also recognize that some aspects of the advanced approaches may be appropriate for the larger, more complex System institutions. However, we are still reviewing the advanced approaches of Basel II and its potential application to the System. Therefore, we are not seeking comments on specific aspects of the advanced approaches at this time. Rather, we are considering the overall regulatory capital framework for the System in light of the changes occurring in the financial services industry and recent best practices for economic capital modeling.

Question 15: We seek comment on the most appropriate risk-based capital framework for the System and the reasons we should implement one framework over another. Should we consider creating a uniform regulatory capital structure for the System or a multi-dimensional regulatory structure and allow each System institution the option of choosing which capital framework it will apply? How might this new risk-based capital framework increase the costs or regulatory burden to the System? Would the increased costs be justified by improved risk sensitivity, risk management, and more efficient capital allocation?

N. Reporting Requirements and Transition Period[60]

The other Federal financial regulatory agencies have announced that they will be replacing Basel IA with a proposed rule that would provide all non-core banks the option of adopting the standardized approach under Basel II. Their stated intent is to finalize a standardized approach for non-core banks before the core banks begin their first transition period year under the advanced capital framework. Our objective is to minimize, to the extent possible, the time interval between the issuance of their final rule and ours. We also need a transition period to make appropriate modifications to the Call Reporting System to track the new risk-based capital requirements.

Question 16: We seek comment on an appropriate timetable for implementing our new risk-based capital rules. Specifically, what is an appropriate time interval between the issuance of the other Federal financial regulatory agencies' final rule on the standardized approach of Basel II and ours? How long should the transition period be to allow System institutions to adjust to the new risk-based *capital rules?*

Question 17: Additionally, we seek comment on any other methods that may be used to increase the risk sensitivity of our risk-based capital rules.

Dated: October 25, 2007

Roland E. Smith,
Secretary,
Farm Credit Administration Board.

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[1]The System was created by Congress in 1916 and is the oldest GSE in the United States. System institutions provide credit and financially related services to farmers, ranchers, producers or harvesters of aquatic products, and farmer-owned cooperatives. They also make credit available for agricultural processing and marketing activities, rural housing, certain farm-related businesses, agricultural and aquatic cooperatives, rural utilities, and foreign and domestic entities in connection with international agricultural trade.

[2]Banking organizations include commercial banks, savings associations, and their respective bank holding companies.

[3]Our regulations can be accessed at http://www.fca.gov/index.html.

[4]The Basel Committee on Banking Supervision was established in 1974 by central banks with bank supervisory authorities in major industrialized countries. The Basel Committee formulates standards and guidelines related to banking and recommends them for adoption by member countries and others. All Basel Committee documents are available at http://www.bis.org.

[5]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 financial regulatory agencies."

[6]See 53 FR 39229 (October 6, 1988).

[7]Pub. L. 100-233 (January 6, 1988), section 301. The 1987 Act amended many provisions of the Farm Credit Act of 1971, as amended, which is codified at 12 U.S.C. 2001 et seq.

[8]See 62 FR 4429 (January 30, 1997).

[9]See 63 FR 39219 (July 22, 1998).

[10]See 70 FR 35336 (June 17, 2005).

[11]See www.bis.org/publ/bcbsca.htm for the 2004 Basel II Accord as well as updates in 2005 and 2006.

[12]See 71 FR 55830 (September 25, 2006). This document is at http://www.federalreserve.gov/generalinfo/basel2/USImplementation.htm.

[13]Core banks are banking organizations that have consolidated total assets of $250 billion or more or have consolidated on-balance sheet foreign exposures of $10 billion or more.

[14]Opt-in banks are banking organizations that do not meet the definition of a core bank but have the risk management and measurement capabilities to voluntarily implement the advanced approaches of Basel II with supervisory approval.

[15]A banking organization computes internal estimates of certain key risk parameters for each credit exposure or pool of exposures and feeds the results into regulatory formulas to determine the risk-based capital requirement for credit risk.

[16]Internal operational risk management systems and processes are used to compute risk-based capital requirements for operational risk.

[17]The other Federal financial regulatory agencies also seek comments on whether core and opt-in banks should be permitted to use other credit and operational risk approaches.

[18]71 FR 77446 (December 26, 2006). This document is at http://www.federalreserve.gov/generalinfo/basel2/USImplementation.htm.

[19]72 FR 34191 (June 21, 2007).

[20]Joint Press Release, "Banking Agencies Reach Agreement On Basel II Implementation," (July 20, 2007). This document is at http://www.occ.gov/ftp/release/2007-77.htm.

[21]Questions 1, 3, 4, 5, 9 and 10 in this ANPRM are identical to those numbered questions posed in our previous ANPRM. Questions 2, 6 and 11 are slightly different. Question 7 in this ANPRM replaces Questions 7 and 8 in our previous ANPRM. Questions 8, 12, and 16 are new to this ANPRM. Questions 13 through 15 are identical to Questions 12 through 14 in our previous ANPRM. Question 17 is identical to Question 15 in our previous ANPRM.

[22]Please note that any data you submit will be made available to the public in our rulemaking file.

[23]FCA's risk-weight categories are set forth in 12 CFR 615.5211.

[24]Basel IA proposed adding risk-weight categories of 35, 75, and 150 percent.

[25]A NRSRO is a credit rating organization that is recognized by and registered with the Securities and Exchange Commission (SEC) as a nationally recognized statistical rating organization. See 12 CFR 615.5201. See also Pub. L. 109–291.

[26]See 68 FR 15045 (March 28, 2003).

[27]Other financing institutions are non-System financial institutions that borrow from System banks. See 69

FR 29852 (May 26, 2004).

[28]These changes are consistent with those of the other Federal financial regulatory agencies. See 70 FR 35336 (June 17, 2005).

[29]See "Revised Regulatory Capital Treatment for Certain Electric Cooperatives Assets," FCA Bookletter BL-053 (February 12, 2007).

[30]Banks include multilateral development banks and securities firms.

[31]Basel IA proposed the categories sovereign entities, non-sovereign entities, and securitizations with different risk-weight categories.

[32]The Farm Credit Banks provide wholesale funding to their affiliated associations who, in turn, make retail loans to eligible borrowers. CoBank, ACB, provides both wholesale funding to its affiliated associations and retail loans to cooperatives and other eligible borrowers.

[33]System banks and associations are permitted to make mission-related investments to agriculture and rural America. See "Investments in Rural America—Pilot Investment Programs," FCA Informational Memorandum (January 11, 2005).

[34]Agricultural businesses include farmer-owned cooperatives, food and fiber processors and marketers, manufacturers and distributors of agricultural inputs and services, and other agricultural-related businesses. Rural businesses include electric utilities and other energy-related businesses, communication companies, water and waste disposal businesses, ethanol plants, and other rural-related businesses.

[35]OECD stands for the Organization for Economic Cooperation and Development. The OECD is an international organization of countries that are committed to democratic government and the market economy. An up-to-date listing of member countries is available at http://www.oecd.org or www.oecdwash.org.

[36]Basel IA proposed assigning lower risk weights to exposures collateralized by securities issued by sovereigns or non-sovereigns that were externally rated at least investment grade.

[37]Basel IA proposed to include guarantees from any entity that had long-term senior debt rated at least investment grade (or issuer rating if a sovereign).

[38]Our risk-based capital rules also assign a 20-percent risk weight to similar GSE and OECD depository institution exposures.

[39]The other Federal financial regulatory agencies stated in Basel IA that they were exploring options to permit certain small business loans to qualify for a 75-percent risk weight.

[40]We present a comparable threshold in terms of U.S. dollars. The standardized approach of Basel II has a threshold of €1 million.

[41]Qualified residential loans are rural home loans (as defined by 12 CFR 613.3030) and single-family residential loans to bona fide farmers, ranchers, or producers or harvesters of aquatic products that meet

the requirements listed in 12 CFR 615.5201.

[42]This section was not in the previous ANPRM.

[43]A CCF is a number by which an off-balance sheet item is multiplied to obtain a credit equivalent before placing the item in a risk-weight category.

[44]Our existing regulations assign a 0-percent CCF to unused commitments with an original maturity of 14 months or less. Unused commitments with an original maturity of greater than 14 months can also receive a 0-percent CCF provided the commitment is unconditionally cancelable and the System institution has the contractual right to make a separate credit decision before each drawing under the lending arrangement. All other unused commitments with an original maturity of greater than 14 months are assigned a 50-percent CCF.

[45]An unconditionally cancelable commitment is one that can be canceled for any reason at any time without prior notice.

[46]Basel IA proposed to retain the 0-percent CCF for all unconditionally cancelable commitments, apply a 10-percent CCF to all other short-term commitments, and retain the 50-percent CCF for all long-term commitments.

[47]Each business line is multiplied by a fixed percentage and then summed together to determine the annual gross income. The eight lines of business are corporate finance (18 percent), trading and sales (18 percent), retail banking (12 percent), commercial banking (15 percent), payment and settlement (18 percent), agency services (15 percent), asset management (12 percent), and retail brokerage (12 percent).

[48]This section was not in the previous ANPRM.

[49]Disclosure is a qualifying criterion under Pillar I to obtain lower risk weightings and/or to apply specific methodologies.

[50]Pillar III of Basel II provides minimum disclosure requirements on capital structure and adequacy, and risk exposure and assessment on credit risk, market risk, operational risk, equities, and interest rate risk in the banking book.

[51]Disclosure of key capital ratios should be made on a quarterly basis. Qualitative disclosures providing a general summary of a bank's risk management objective and policies, reporting system and definitions may be published on an annual basis.

[52]U.S. Basel II banks are encouraged to provide this information in one place on the entity's public Web site.

[53]These disclosures would be tested by external auditors as part of the financial statement audit.

[54]The net collateral ratio is a bank's net collateral as defined in 12 CFR 615.5301(c) divided by the bank's adjusted total liabilities.

[55]<u>See</u> 12 CFR 615.5335(a).

[56]See 12 CFR 3.6(b) and (c); 12 CFR part 208, appendix B and 12 CFR part 225, appendix D; 12 CFR 325.3; and 12 CFR 567.8.

[57]12 CFR part 615, subpart M.

[58]A capital directive is defined in § 615.5355(a) as an order issued to an institution that does not have or maintain capital at or greater than the minimum ratios set forth in 12 CFR 615.5205, 615.5330, and 615.5335, or established under subpart L of part 615, or by a written agreement under an enforcement or supervisory action, or as a condition of approval of an application. The FCA's authority is set forth in sections 4.3(b)(2) and 4.3A(e) of the Farm Credit Act (12 U.S.C. 2154(b)(2) and 2154a(e)).

[59]See 12 U.S.C. 1831o for the prompt corrective action provisions that apply to commercial banks and savings associations.

[60]This section was not in the previous ANPRM.

73 FR 15955, 03/26/2008

Handbook Mailing HM-08-1

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AC25

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Capital Adequacy--Basel Accord

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking (ANPRM); extension of comment period.

SUMMARY: The Farm Credit Administration (FCA, Agency or we) is extending the comment period on our ANPRM that seeks comments to facilitate the development of enhancements to our regulatory capital framework to more closely align minimum capital requirements with risks taken by Farm Credit System (FCS or System) institutions. We are extending the comment period so all interested parties will have additional time to provide comments.

DATES: You may send comments on or before December 31, 2008.

ADDRESSES: We offer several methods for the public to submit comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the Agency's Web site or the Federal eRulemaking Portal. Regardless of the method you use, please do not submit your comments multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- Agency Web site: http://www.fca.gov. Select "Legal Info," then "Pending Regulations and Notices."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.
- FAX: (703) 883-4477. Posting and processing of faxes may be delayed, as faxes are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act. Please consider another means to comment, if possible.

You may review copies of comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select “Legal Info,” and then select “Public Comments.” We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Laurie Rea, Associate Director, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4232, TTY (703) 883-4434,

or

Wade Wynn, Policy Analyst, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4262, TTY (703) 883-4434,

or

Rebecca S. Orlich, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION: On October 31, 2007, FCA published a notice in the Federal Register seeking public comment to facilitate the development of a proposed rule that would enhance our regulatory capital framework and more closely align minimum capital requirements with risks taken by System institutions. See 72 FR 61568. The comment period is scheduled to expire on March 31, 2008. In a letter dated March 4, 2008, the Federal Farm Credit Banks Funding Corporation, on behalf of the System banks and associations, requested that the Agency extend the comment period until December 31, 2008. In view of the number and the complexity of the questions asked in the ANPRM, we have granted this request. The FCA supports public involvement and participation in its regulatory process and invites all interested parties to review and provide comments on our ANPRM.

Dated: March 21, 2008

Roland E. Smith,
Secretary,
Farm Credit Administration Board.

73 FR 33931, 06/16/2008

Handbook Mailing HM-08-5

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AC42

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Mission-Related Investments, Rural Community Investments

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA) proposes a new rule that would authorize each Farm Credit System (Farm Credit, System, or FCS) bank, association, and service corporation (institution) to invest in rural communities across America under certain conditions. The proposed rule would allow each System institution to make investments in rural communities that are outside of an urbanized area only for specific purposes. Several provisions in the proposed rule would ensure that System investments in rural America are safe and sound and comply with the Farm Credit Act of 1971, as amended (Act), and other applicable statutes.

DATES: Comments should be received on or before August 15, 2008.

ADDRESSES: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site or the Federal eRulemaking Portal. As faxes are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, please consider another means to submit your comment if possible. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.
- FAX: (703) 883-4477. Posting and processing of faxes may be delayed. Please consider another means to comment, if possible.

You may review copies of comments we receive at our office in McLean, Virginia, or from our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public

Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Laurie Rea, Associate Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA, (703) 883-4414, TTY (703) 883-4434;

or

Dawn Johnson, Policy Analyst, Office of Regulatory Policy, Farm Credit Administration, Denver, CO, (303) 696-9737, TTY (303) 696-9259;

or

Richard A. Katz, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Background

The FCA proposes a new rule, § 615.5176, which would enable System institutions to more effectively serve the needs of rural communities by exercising investment powers under the Act. The proposed rule focuses on specific needs in rural communities. Essentially, the proposed rule would authorize two separate types of investments that System institutions could make in America's rural communities. First, System institutions could invest in debt securities that would involve projects or programs that benefit the public in rural communities. Equity investments in venture capital funds are the second type of investment that the proposed rule would authorize. Venture capital funds create new economic opportunities and jobs in rural communities by providing capital to small or start-up businesses.

The proposed rule would authorize each System institution to make investments in rural areas that according to the terms of the latest United States decennial census have fewer than 50,000 residents and are outside of an urbanized area. The proposed rule would allow System institutions to invest in: (1) Essential community facilities; (2) basic transportation infrastructure; (3) rural communities recovering from disasters; (4) debt securities for rural development projects that the United States, its agencies, any state, Puerto Rico, or a local municipal government sponsors or guarantees; (5) debt securities that support the rural development activities of non-System financial institutions; (6) rural business investment companies; and (7) venture capital funds that invest in rural businesses that create jobs and economic growth under specific conditions. The proposed rule also would allow System institutions to make other investments that are not expressly covered by this regulation with FCA approval. Under the proposed rule, an institution may hold rural community investments in an amount that does not exceed 150 percent of its total surplus. As discussed in greater detail below, other provisions of the proposed rule address safety and soundness and compliance with the Act.

A. The Statutory Basis for the Proposed Rule

System institutions derive their investment authorities from several provisions of the Act. Sections 1.5(15) and 3.1(13)(A) of the Act[1] authorize System banks to invest in securities of the United States and its agencies, and make "other investments as may be authorized under regulations issued by the Farm Credit Administration." Sections 2.2(10) and 2.12(18) of the Act[2] authorize System associations to invest their funds as approved by their district banks in accordance with FCA regulations. A System service corporation is authorized by section 4.25 of the Act[3] to engage in investment activities to the same extent as its System parents.[4]

Investments in rural communities are compatible with the System's statutory mandate. The preamble to the Act clearly states that Congress enacted the law "to provide for an adequate and flexible flow of money into rural areas, and to modernize . . . existing farm credit law to meet current and future rural credit needs, and for other purposes." The preamble and investment provisions of the Act form a broad statutory framework that confers considerable discretion on the FCA to decide the purposes, conditions, and limits for all investment activities at System institutions. In exercising this discretion, the FCA has authorized System institutions to invest their funds in obligations that are suitable for liquidity, risk management, and activities that are closely related to the System's statutory mandate.

In implementing the investment provisions of the Act, the FCA has taken a cautious and incremental approach in approving System investments for mission-related purposes. Since Congress enacted the Act in 1971, the FCA has approved new regulations and programs that authorize the System to make specified investments in agriculture and rural communities, subject to certain conditions and limits. The factors that the FCA considers whenever it decides to approve new mission-related investments are: (1) The financial needs of agriculture and rural communities; (2) new investment products offered in the marketplace; (3) the System's status as a Government-sponsored enterprise (GSE); and (4) compliance with the Act and other applicable statutes. Under FCA regulations and programs, System investments in agriculture and rural communities have remained small because lending to farmers, ranchers, cooperatives, and other eligible borrowers is the primary activity of System institutions under the Act. Additionally, most mission-related investments that the FCA has approved are related to the System's expertise in financing agriculture, rural housing, and infrastructure in rural areas.

Historically, the FCA has authorized System institutions to invest in debt securities, but not in equity securities of non-System entities. In 2002, Congress granted System institutions express authority to invest in rural business investment companies (RBICs), which are venture capital funds that the United States Department of Agriculture (USDA) funds and oversees. The FCA believes that allowing the System to invest in venture capital funds that hold small equity positions in start-up rural enterprises is consistent with congressional intent. As discussed in greater detail below, the proposed rule would implement the provisions of title VI of the Farm Security and Rural Investment Act of the 2002[5] and the Act by allowing System institutions to invest in RBICs and other venture capital funds that provide start-up money to rural entrepreneurs.

In accordance with the Act, the FCA has enacted several regulations since 1971 that authorize System investments in agriculture and America's rural communities. The first mission-related investments that the FCA approved were farmers' notes.[6] Since 1972, FCA regulations have authorized System banks and associations to invest in obligations of States, municipalities, and local governments. In 1993, a new regulation authorized System institutions to purchase and hold mortgage securities issued or guaranteed by the Federal Agricultural Mortgage Corporation (Farmer Mac). In 1999, the FCA amended another regulation to permit investment in asset securities backed by agricultural equipment. An existing regulation, § 615.5140(e), allows Farm Credit institutions to hold other investments that the FCA approves on a case-by-case basis. This regulatory framework guides investment practices at Farm Credit institutions and ensures that System investments comply with law and are safe and sound.

Since 2005, the FCA has approved requests by System banks and associations, on a case-by-case basis, to initiate pilot programs for investing in America's rural communities under specified conditions. Under these FCA-approved pilot programs, System institutions acquired expertise and became active in making investments that provided funding for essential projects in rural communities.

Based on the positive experience of these pilot programs, the FCA is proposing a rule that will allow all System banks, associations, and service corporations to make certain investments in rural communities under prescribed conditions without prior FCA approval. This proposed rule would permit the rural-based System to use its expertise and a portion of its financial resources to support rural economic growth and development by investing in those projects and programs in America's rural communities that often have difficulty attracting financing at affordable rates.

The proposed rule implements the investment provisions of the Act by ensuring that: (1) System institutions invest in rural communities only for specific purposes; and (2) all instruments purchased and held by Farm Credit institutions are investment securities in accordance with market practices and securities laws. Investments in rural communities also would be subject to a portfolio limit and other controls to ensure that FCS rural community investment activities comply with the Act and are safe and sound.

The FCA emphasizes that lending to farmers, ranchers, aquatic producers and harvesters, farm-related businesses, rural homeowners, cooperatives, and rural utilities remains the primary purpose of the System. However, within the parameters prescribed by the proposed rule, System investments, which help strengthen the economic viability of rural communities, are compatible with the preamble and several provisions of the Act. Investing in rural communities enables Farm Credit to fulfill its mission by helping sustain rural communities on which the System's borrowers and owners are dependent for their livelihoods.

B. <u>Why Investments in Rural Communities are Important</u>

The FCA proposes this rule to allow the System to make investments in rural communities and to support and supplement investments by government, commercial banks, investment banks, and venture capital funds. The FCA believes that this new rule will enable the System to more fully assist rural communities in financing projects that are designed to provide essential facilities, infrastructure, and services to residents. As discussed in greater detail below, System institutions made investments under FCA authorized pilot programs, which demonstrated that the FCS is both locally and regionally positioned to effectively participate and assist rural development networks that strive to address rural needs. The proposed rule is designed to enable FCS institutions to collaborate and partner in rural development initiatives that advance the System's mission and its capacity to serve as a financial intermediary promoting the flow of money into rural areas.

Many rural communities are struggling to retain economic viability and vitality that can provide economic opportunities and a better quality of life for their residents. Rural communities face numerous demographic, social, and economic challenges in meeting the needs of their residents. As a result, rural communities often find it difficult to provide the essential facilities, infrastructure, and services that their residents need. For example, an aging population in rural areas requires medical and assisted health care facilities. However, rural communities often have fewer health care providers and facilities to meet the increasing medical needs of its growing elderly population.[7]

Also, a large gap persists between rural and metropolitan residents who have earned college degrees. This gap is reinforced by a lower demand for workers with post-secondary degrees in rural areas, which in turn, contributes to the out-migration of skilled workers.[8] These factors place rural communities at a disadvantage in attracting businesses that offer higher wages and better job benefits to employees. Essential facilities, infrastructure, and services in rural areas often lag behind those in metropolitan areas. This is another factor that limits the ability of rural communities to attract and retain businesses that provide employment and economic opportunities. These obstacles to rural economic development and revitalization are further compounded by funding challenges for projects that are designed to assist rural communities in resolving these problems.

Funding for economic growth and development projects in rural communities is available from a variety of sources, most notably the Federal and State governments, and private-sector financiers, including commercial and investment banks. Each of these entities faces challenges in providing rural communities with the funding needed for these projects. Efforts by Federal or State governments to help rural communities are often curtailed by budget constraints. Also, many rural community banks are willing to provide short-term funding, but find it difficult to provide the additional long-term capital investment needed for facilities in rural areas.[9] Essential facilities and large capital improvements, such as critical care access hospitals, require a large capital investment that is repaid over an extended period of time. In many cases, no single investor is willing and able to supply all of the capital necessary for such projects, and rural communities must depend on a combination of government and private-sector financial sources and local donations.[10] Another obstacle is that rural development projects in remote rural locations typically involve higher costs and greater risks, which deter investors. For these reasons, government and private-sector financial resources often are insufficient to fully fund many necessary and worthwhile projects that rural residents need.

System institutions are an integral part of rural America. The farmers and ranchers who borrow from and own the FCS live and work in rural communities. These System stockholders and their families depend on local rural communities for essential services, employment, and other economic opportunities. Today, the majority of farm household income is derived from off-farm sources.[11] As a result, farm families depend on local rural communities for employment that supplements farm income. Further, agricultural production is one of the most hazardous industrial sectors.[12] Farmers and ranchers confront the same problems as other residents of America's rural communities in obtaining access to quality hospitals, medical facilities, schools and essential services.

System institutions are active in financial markets that serve regional and local rural areas across the United States. For this reason, the System is familiar with the challenges that rural communities face in meeting the needs of both farm and nonfarm rural residents. The System has the financial capacity to invest in rural development, and this proposed rule would advance the System's contributions to rural development efforts.

C. Investments in Rural Communities Made Under Pilot Programs

Over the past 3 years, a number of System institutions have developed programs to make investments in rural communities through FCA-approved pilot programs. As a result of the investments made under these pilot programs, rural communities were able to address specific regional needs because these investments provided greater access to capital for community facilities, revitalization projects, and other economic development initiatives. These investments also provided additional liquidity into rural financial markets. In several cases, these investments helped provide capital at more affordable terms and rates, which in turn made these projects more feasible.

The pilot programs have demonstrated that Farm Credit institutions have the capacity and willingness to work collaboratively with rural communities and financial institutions to address local and regional rural economic development needs. As previously discussed, many rural development projects are reliant on multiple partners for success. In making rural community investments under the pilot programs, System institutions partnered with: Federal, State, and regional rural development authorities; non-System financial institutions including rural community banks; nonprofit organizations; and venture capital funds. For example, System investments under the pilot programs have provided capital for rural hospitals designated as critical access facilities, which were sponsored, in part, by the USDA's Rural Development Community Facilities Program. Other examples of specific System investments that have made a positive difference in rural communities include investments in: medical and mental clinics; treatment facilities for adolescents and adults; living and nursing centers for the elderly; schools; and community facilities. Several projects, which were sponsored by regional or State development authorities, modernized obsolete facilities for value-added agricultural products, or created new facilities to promote local economic growth. These projects were designed to promote economic growth in rural areas by attracting and promoting businesses that create or retain jobs in these rural communities.

Non-System financial institutions and venture capital funds have also benefited from investments that System institutions made under the pilot programs. For example, System institutions have helped to increase liquidity at several rural community banks by buying bonds that support the rural development efforts of these banks. These investments enabled these banks to reduce the long-term financing costs for specific rural development projects. Additionally, investments in regional investment networks provided venture capital to rural entrepreneurs for start-up businesses that contributed to the vitality of rural communities. System institutions were prudent in undertaking investment activities in rural communities and assumed reasonable risks within pilot program conditions.

In addition to the pilot programs, grant programs and charitable contributions at many System institutions complement their commitments to the citizens of local rural communities. Although the proposed rule does not specifically address grants, System institutions have authority under the incidental power provisions of the Act to make charitable grants and donations.[13] The FCA continues to encourage FCS institutions to consider making charitable donations and contributions to worthwhile causes in the communities they serve. System institutions have contributed to a wide variety of community organizations and entities, including emergency and medical services, agricultural and rural community development educational programs, and value-added agricultural product initiatives. Charitable grants by System institutions complement rural community investment programs and are an additional way for Farm Credit institutions to further the System's mission and help enhance the quality of life for residents in rural communities.

II. Section-by-Section Analysis

A. Rural Communities

Proposed § 615.5176(a) would authorize Farm Credit banks, associations, and service corporations to make rural community investments. Proposed § 615.5176(a) also provides that FCS institutions may make these investments only in areas outside of an "urbanized area"[14] as defined by the latest decennial census of the United States. For the purposes of this proposed rule, areas outside of an urbanized area are "rural." The proposed rule would authorize the FCS to make rural community investments in areas that the United States Census Bureau determined in the latest decennial census to have a population of less than 50,000 residents. For the purposes under this proposed rule, the geographic area includes any State within the United States and the Commonwealth of Puerto Rico.

The FCA considered numerous definitions of "rural," recognizing there is no single, universally preferred definition of "rural" that policymakers commonly use.[15] In fact, more than 15 definitions of "rural" are currently used by different Federal agencies for various programs.[16] In developing the proposed rule, the FCA relied on Census Bureau terminology to ensure that the geographic areas in which investments are permitted are readily identifiable and easily distinguished.

In determining which geographic areas should qualify under the proposed rule, the FCA seeks to include those areas with sufficient population densities to support health care and other essential facilities serving rural residents, while prohibiting investments in urbanized areas. For example, hospitals and other health care facilities that primarily serve rural geographic areas are typically located in areas that have less than 50,000 residents. Also, whenever Congress has expressly authorized FCS institutions to lend or invest in rural development projects, it has allowed these activities in communities with populations of 50,000 or fewer residents.[17] Additionally, most Federal agencies and demographic experts have determined that densely populated areas with 50,000 or more inhabitants are urbanized areas. For this reason, investments authorized under the proposed rule would allow System institutions to invest in areas with populations of less than 50,000 residents based on the latest decennial census of the United States.

By allowing the System to invest in rural communities that have fewer than 50,000 residents, the proposed rule provides "an adequate and flexible flow of funds into rural areas" in accordance with the Act, while precluding System institutions from investing in urbanized areas. Information is publicly available on the Census Bureau's Web site, including census population statistics and maps. As a result, System institutions and other interested parties are able to determine if a particular location is within a "rural" community for the purposes of § 615.5176(a).

B. Debt Securities

Proposed § 615.5176(b) would authorize System institutions to invest in rural communities by purchasing and holding debt securities for purposes specified in § 615.5176(b)(1) through (5). The proposed rule defines debt securities as obligations that are commonly recognized in capital markets as a medium for investment, including government obligations, corporate bonds, revenue bonds, asset-backed securities and mortgage securities. Proposed § 615.5176(b) expressly excludes commercial loans and instruments or transactions that are more similar to commercial loans than to traditional investment instruments in order to clarify the statutory distinction between loans and investments. Under the proposed rule, System institutions could not use their authority to invest in rural communities to make loans to otherwise ineligible borrowers.

1. Essential Community Facilities

Proposed § 615.5176(b)(1) would authorize System institutions to invest in debt securities that finance essential community facilities, such as hospitals, health care facilities, emergency services, and schools. Many essential community facilities are owned and operated by State, local, or municipal governments. In other cases, quasi-governmental or highly regulated private and nonprofit entities own and operate essential community facilities. Government obligations and revenue bonds often fund the construction and renovation of these facilities. Rural communities are currently facing increasing difficulty in funding these facilities because of deteriorating liquidity in financial markets. System institutions can help alleviate this problem by purchasing and holding debt securities as investments in community facilities that provide essential services to rural residents.

2. Basic Transportation Infrastructure

Financing basic transportation infrastructure, such as roads, bridges, and other public transportation systems, is another authorized investment purpose under the proposed rule. The public sector owns, maintains, and operates most basic transportation infrastructure in the United States. Most rural transportation facilities are operated by public agencies or nonprofit groups, with a small percentage operated by private entities. Transportation projects are another area where the System could significantly help rural communities build and improve infrastructure, which would strengthen their economic viability. Rural communities and particularly agricultural industries, depend on quality transportation systems, which are critical in supplying inputs, shipping and distributing outputs and products, and supporting economic development. Proposed § 615.5176(b)(2) would authorize System institutions to purchase government obligations, revenue bonds, and other debt obligations that support basic transportation infrastructure.

3. Revitalization of Rural Communities After a Disaster

Proposed § 615.5176(b)(3) would permit System institutions to purchase debt securities in revitalization projects that help rebuild rural areas devastated by disasters where an emergency has been declared pursuant to law. These investments must support local efforts and residents by contributing to the economic recovery of the affected rural community.

4. Rural Development Projects with Government Sponsorship or Guarantees

Under proposed § 615.5176(b)(4), System institutions could invest in debt securities that a government issues, sponsors, or guarantees under programs to fund rural community development projects. Without crucial financial support from Federal, State, or local governments, rural communities would face greater difficulty in funding vital development projects. By investing in debt securities for rural economic development under government programs, the System assists rural communities across America in accordance with its statutory mandate. By proposing § 615.5176(b)(4), the FCA is encouraging System institutions to work with Federal, State, and local governments and their partners to invest in projects that bring jobs, infrastructure, community facilities, and vital services to rural areas and their residents.

Proposed § 615.5176(b)(4)(i) covers debt securities that the United States and its agencies issue, sponsor, or guarantee under programs that have the specific purpose of directly financing economic development in rural communities. The FCA emphasizes that the proposed rule does not require the full faith and credit of the United States for bonds issued or guaranteed by agencies of the United States. However, these investments are authorized only if the Federal agency issues or guarantees these bonds or obligations in accordance with a program that has the specific purpose of promoting economic development in rural areas. For example, the Tennessee Valley Authority, the Small Business Administration, and various agencies in the USDA and the Department of Housing and Urban Development issue and guarantee bonds under specific programs for infrastructure, facilities, and other development projects in rural areas, and System investment in these obligations would be authorized by the proposed rule.

Other Federal agencies operate programs in both metropolitan and rural areas which are not part of any specific rural development mission. Bonds and other obligations issued or guaranteed under such programs would not qualify as investments under the proposed rule. For example, the proposed rule would not authorize the FCS to invest in mortgage securities issued or guaranteed by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation because the purpose of these securities is to enhance the liquidity of residential home loans throughout the United States, rather than to promote rural development. Another regulation, § 615.5140, permits System institutions to make investments for liquidity and risk-management purposes in bonds and obligations, including residential mortgage securities, that Federal agencies issue or guarantee under programs that are unrelated to rural development. The proposed rule focuses on investments in rural communities and would not authorize System institutions to hold residential mortgage securities issued by other GSEs, but the FCA continues to study this issue.

Proposed § 615.5176(b)(4)(ii) would allow System institutions to invest in debt securities that any State, the Commonwealth of Puerto Rico, a local or municipal government, or other political subdivision of a State, issues, sponsors, or guarantees that are specifically related to development in rural communities. Many local or municipal governments and other political subdivisions, such as special districts, often sponsor particular rural development projects by providing tax incentives or other benefits to private-sector obligors who issue revenue bonds. These revenue bonds, which help finance rural development projects, would qualify as investments that FCS institutions could purchase and hold under proposed § 615.5176(b)(4)(ii). This provision would also allow System institutions to invest in mortgage securities that are issued or guaranteed by State or local agencies that specialize in rural development.

5. Rural Development Projects Financed by Non-System Financial Institutions

Proposed § 615.5176(b)(5) would allow System institutions to invest in debt securities issued by non-System financial institutions. The proposed rule would authorize System institutions to purchase these debt securities to increase financial assistance to rural communities and improve the liquidity of rural financial markets. This provision would enhance cooperation between System and non-System financial institutions and ultimately benefit rural communities. System institutions may purchase asset-backed securities, covered bonds, or similar types of bonds issued by non-System financial institutions directly or through trusts that supply funds to non-System financial institutions for rural development. Investments made under the pilot programs evidence that securities, including commercial bank bonds issued by rural community banks and purchased by System institutions, can effectively increase bank liquidity. These investments benefit rural communities and residents, while establishing partnerships between non-System and System institutions.

C. Equity Investments

Equity investments in venture capital funds are another type of investment that the proposed rule would authorize FCS institutions to purchase and hold. Under this provision of the proposed rule, System institutions could invest in venture capital funds that provide capital to start-up and small private-sector enterprises that bring jobs and economic opportunities to rural communities. Venture capital funds that operate in the United States invest only 1.6 percent of their funds in rural community enterprises, although these enterprises represent 19.2 percent of all businesses.[18] System institutions could make a small, but meaningful, contribution to rural economic development by investing in venture capital funds that provide capital into rural enterprises. As discussed in greater detail below, System institutions would hold only small, passive investment positions in venture capital funds because of statutory and regulatory restrictions.

Proposed § 615.5176(c) would authorize System institutions to make equity investments in two types of entities, RBICs and venture capital funds, for the purpose of providing equity capital to rural business enterprises. Rural entrepreneurs often lack sufficient equity capital to establish and expand businesses that are the mainstay of prosperous rural economies. Venture capital funds provide equity capital in rural business enterprises, which promote economic development and job opportunities in rural communities.

1. Rural Business Investment Companies

Proposed § 615.5176(c)(1) would authorize System institutions to purchase and hold equity investments in RBICs that are established and operate in accordance with 7 U.S.C. 2009cc et seq. As discussed earlier, the Farm Security and Rural Investment Act of 2002 created the Rural Business Investment Program and expressly authorized any Farm Credit System institution to establish and invest in RBICs. Congress intended to promote economic development, create wealth, and expand job opportunities in rural areas through RBIC equity investments. The System's statutory authority to establish and invest in RBICs is incorporated into proposed § 615.5176(c)(1). The proposed rule would enable System institutions to invest in RBICs to the fullest extent allowed by 7 U.S.C. 2009cc et seq. The FCA emphasizes that proposed § 615.5176(c)(1) would authorize System institutions to invest in both leveraged and non-leveraged RBICs.

2. Venture Capital Funds

Proposed § 615.5176(c)(2) would authorize System institutions to invest in venture capital funds which, in turn, invest in rural businesses that provide job opportunities. Under this provision, System institutions would be able to indirectly provide rural entrepreneurs needed equity capital through venture capital funds, such as regional investor networks, which have investment objectives similar to RBICs.

The Center for the Study of Rural America of the Federal Reserve Bank of Kansas identified a significant need for equity capital for rural entrepreneurs because entrepreneurial activity is strongly linked to economic growth.[19] For this reason, experts conclude that additional focus on rural entrepreneurship can be an effective strategy in combating the decline of traditional resource-based businesses in rural areas.[20] However, rural economies have difficulty attracting venture capital because metropolitan areas usually offer better profits. Policy officials and experts agree that entrepreneurship in remote and sparsely populated rural areas can be challenging because access to skilled labor, technology, and capital is more limited. Investments in venture capital funds that focus on rural entrepreneurs can effectively begin to overcome these barriers to rural businesses.

Proposed § 615.5176(c)(2) would place specific restrictions on System investment in venture capital funds to ensure that these investments remain small and passive. Additionally, these controls would minimize potential financial risk to the System institutions, while providing the System with flexibility to invest in rural development under the Act.

Proposed § 615.5176(c)(2)(i) would control financial risk by prohibiting any System institution from investing more than 5 percent of its total surplus in venture capital funds and more than 2 percent of its total surplus in any one venture capital fund. The FCA emphasizes that this limit on venture capital funds in proposed § 615.5176(c)(2)(i) is in addition to the overall limit in proposed § 615.5176(e)(i), which prevents total rural community investments at any FCS institution from exceeding 150 percent of its total surplus.

The restrictions in proposed § 615.5176(c)(2)(ii) and (iii) would prevent System institutions from controlling and managing venture capital funds. Proposed § 615.5176(c)(2)(ii) would prohibit any FCS institution from holding more than 20 percent of the voting equity of any venture capital fund. The purpose of this provision is to allow System institutions to invest in venture capital funds that focus on rural areas, while imposing a reasonable limit that prevents any System institution from gaining a controlling interest in any fund. Proposed § 615.5176(c)(2)(iii) would prohibit any FCS institution from participating in the routine management or operation of a venture capital fund.

Finally, proposed § 615.5176(c)(2)(iv) and (v) would establish controls to avoid potential conflicts of interest. Proposed § 615.5176(c)(2)(iv) would prohibit any director, officer, or employee of a System institution from serving as a director, officer, employee, principal shareholder, or trustee of any venture capital fund or of any entity funded by, or affiliated with, the venture capital fund. Proposed § 615.5176(c)(2)(v) would prohibit any System institution from participating in any decision or action of a venture capital fund involving or affecting any customer of the institution. Although proposed § 615.5176(c)(2)(v) would permit a System institution to invest in venture capital funds that hold equity in one of its borrowers, the institution could not participate in decisions or actions that affect such customers. Additionally, the proposed rule does not prohibit System institution directors, officers, or employees from serving in an investment screening or other advisory capacity to a venture capital fund, subject to the restrictions discussed above. System institution representatives serving in an advisory capacity to a venture capital fund also remain subject to FCA conflict of interest regulations and institution policies.

D. Other Investments Approved by the Farm Credit Administration

The FCA's experience with the pilot programs reveals that the types of System investments may change as the needs of rural communities evolve. For this reason, the FCA believes that the new regulation should contain a mechanism for approving investments that currently do not exist, but may emerge in the future. Currently, § 615.5140(e) provides the FCA with the authority to approve new investments that are not specifically authorized by regulation.

Proposed § 615.5176(d) establishes specific criteria for System institutions to apply to the FCA for permission to hold investments that are not expressly authorized by this regulation. Under this proposal, written requests by System institutions would: (1) Describe the proposed project or program in detail; (2) explain its risk characteristics; and (3) demonstrate how such investments are consistent with the System's statutory mandate to serve agriculture and rural communities. In approving such requests, the FCA may impose additional or more stringent conditions than the requirements of this regulation to ensure safety and soundness or compliance with law.

E. Restrictions on Rural Community Investments

Other requirements governing System investments in rural communities are covered by proposed § 615.5176(e). These requirements either pertain to safety and soundness or implement statutory requirements.

1. Portfolio Limit

Proposed § 615.5176(e)(1) would authorize each System bank, association, or service corporation to make rural community investments in an amount not to exceed 150 percent of the institution’s total surplus. The proposed portfolio limit on rural community investments ensures that lending to farmers, ranchers, aquatic producers, cooperatives, and other borrowers that own the FCS remains the primary activity of System institutions. At the same time, the proposed limit provides the FCS with the flexibility to make investments in an amount that offers meaningful assistance to rural communities and their residents. This limit on rural community investments is compatible with limits that the Act and other FCA regulations impose on System activities that are related to the System’s mission.

Based on financial information reported as of December 31, 2007, the proposed limit would authorize the System to invest up to a total of $35.8 billion in rural community investments.[21] For example, this would permit an FCS association with $1.0 billion in assets and $150.0 million in total surplus to invest up to $225.0 million in rural communities.

The FCA considered the following factors when it decided to propose 150 percent of total surplus as the portfolio limit: (1) The safety and soundness of FCS institutions; (2) the significant needs of rural communities; (3) the FCS's ability and capacity to assist rural communities, and (4) the ability of FCS institutions to fulfill mission objectives. Total surplus provides a basis for each institution's risk tolerance level, and the FCA has historically used this standard to limit System investments in unrated obligations that are less liquid. System institutions also use limits based on similar capital measures to ensure that asset and portfolio concentrations are safely and soundly managed.

This proposed limit also is based on the limits established for the pilot programs. The FCA established individual institution limits equal to 100 percent of total surplus (or in some cases 10 percent of total loans) for investments held under specific pilot programs, and 150 percent of total surplus for an institution's portfolio of all rural community investments. The pilot programs evidence that System institutions exercised caution when making investments in rural communities. Institutions have not approached the portfolio limit. Although the proposed rule establishes an upper regulatory portfolio limit, the FCA expects that each System institution would determine an appropriate internal portfolio limit based on the individual institution's objectives, capital position, risk tolerance, and other factors that it considers appropriate, in accordance with § 615.5133(c).

The FCA also considered the System's need to establish a program of sufficient size that could adequately deliver benefits to rural communities while balancing operational efficiency needs. In establishing the portfolio limit, the FCA sought to ensure that each System institution, large or small, could effectively partner with government agencies and non-System financial institutions in projects that may positively affect their local rural communities.

The current credit crisis emphasizes the importance of funding for rural development projects and enhancing the liquidity of rural credit markets. The portfolio limit curtails the maximum risk exposure of System institutions, and it also encourages partnerships with non-System financial institutions and government agencies that are active in rural development. Collaboration between System institutions and larger, more established financial investors is a way to help rural communities access financing for vital projects, especially during times of economic uncertainty.

2. <u>Obligor Limit</u>

Proposed § 615.5176(e)(2) would establish an obligor limit for investments in rural communities. This provision would not allow any System institution to invest more than 15 percent of its total surplus in investments issued by a single entity, issuer, or obligor. However, the obligor limit would not apply to obligations issued or guaranteed on the full faith and credit of the United States, its agencies, instrumentalities, or corporations. In the event only a portion of the obligation is guaranteed, the non-guaranteed portion of the obligation would remain subject to the obligor limit.

This obligor limit is designed to control undue credit risk from a single counterparty on the capital of any System institution and provide sufficient diversification of an institution's rural community investment portfolio. For safety and soundness reasons, the FCA decided that the obligor limit for rural community investments should be lower than the 20 percent of total capital obligor limit established for investments held by System institutions to maintain liquidity and manage market risks in § 615.5140(d). In contrast to the liquid and marketable securities held under § 615.5140, rural community investments are often unrated and, therefore, capital markets would consider them less liquid. The FCA anticipates that most rural community investments would be held to maturity and would not trade. For these reasons, the FCA proposes an obligor limit for rural community investments that does not exceed 15 percent of the total surplus of each System institution.

This regulatory provision would also require a System institution to count securities that it holds through an investment company towards this 15-percent obligor limit to prevent undue risk concentrations. This provision provides an exception when the investment company's holding of the security of any one issuer does not exceed 5 percent of the investment company's total portfolio. The FCA patterned this provision after § 615.5140(d)(2), which applies to investments that FCS institutions hold through investment companies for the purposes of maintaining liquidity or managing market risks.

The FCA emphasizes that proposed § 615.5176(e)(2) establishes a maximum obligor limit for rural community investments. The FCA expects every Farm Credit institution to establish internal obligor limits based on its financial condition and the size and complexity of securities that it contemplates buying and holding. The obligor limit that each System institution sets should be based on both identified risks and its own risk-bearing capacity.

3. Maturities for Debt Securities in Rural Communities

Proposed § 615.5176(e)(3) would require most rural community investments to mature in no more than 20 years. However, debt securities may mature in not more than 40 years if the United States or its agencies provide a guarantee or a conditional commitment of guarantee for 50 percent or more of the total issuance or obligation. Proposed § 615.5176(e)(3) establishes terms to maturity that are flexible enough to accommodate typical rural development projects that this rule would authorize. This regulatory approach would enable System institutions to participate in USDA and other State rural development programs that provide a supplemental or partial guarantee, which contributes to, or enhances, whole-project financing. Also, investments that fund essential rural community facilities, such as hospitals, police and fire stations, and other emergency service facilities, typically require project financing over longer terms to maturity.

4. Exclusion from the Liquidity Reserve

Proposed § 615.5176(e)(4) would require System banks to exclude rural community investments from their liquidity reserve under § 615.5134 of this part. System banks may purchase and hold the eligible investments listed in
§ 615.5140 to maintain liquidity reserves, manage interest rate risk, and invest surplus short-term funds in accordance with § 615.5132. Only investments that can be promptly converted into cash without significant loss are suitable for achieving these objectives. Rural community investments are not suitable for liquidity purposes or market risk management because these investments do not typically carry ratings assigned by a Nationally Recognized Statistical Rating Organization and are not actively traded in the established secondary markets.

5. Association Investments

Proposed § 615.5176(e)(5) would implement sections 2.2(10) and 2.12(18)[22] of the Act, which require each funding bank to supervise and approve the investment activities of its affiliated associations. System banks may discharge their statutory and regulatory responsibility to approve and supervise an association's rural community investments through covenants in the general financing agreement, policies, or other appropriate formats. System banks may also provide advisory, analytical, and research services that help their affiliated associations to devise strategies for investing in rural communities and managing these assets.

6. Attribution of Service Corporation Investments

Proposed § 615.5176(e)(6) would require System service corporations to attribute all rural community investments to their System institution parents based on the ownership percentage of each bank or association. This provision would prevent FCS institutions from utilizing service corporations to exceed the regulatory limits on rural community investments.

F. Management of Rural Community Investments

Proposed § 615.5176(f) addresses rural community investment management practices at FCS institutions and ensures that System institutions invest in rural communities in a safe and sound manner. If a Farm Credit System institution chooses to invest in rural communities, proposed § 615.5176(f) would require its board of directors to first adopt written policies for managing the institution's investments. These investment management policies must be appropriate for the levels, types, and complexities of each institution's rural community investments. Proposed § 615.5176(f) would also require the board of directors ensure the institution's implementation of procedures and internal controls that ensure compliance with the board's policies and the regulation.

Additionally, proposed § 615.5176(f) would require these written policies to comply with § 615.5133, which governs management practices for investments held for liquidity and risk management. Although rural community investments differ from liquid investments, strong and disciplined investment management practices are essential to the safety and soundness of all investment activities within System institutions. As a result, sound investment management practices prescribed by § 615.5133 are also applicable to rural community investments and, for this reason, the FCA is extending § 615.5133 to rural community investments.

Existing § 615.5133 requires a System institution's investment management policies to address risk tolerance, delegations of authority, internal controls, securities valuation, and reporting to the board. Also, § 615.5133 requires that investment policies be appropriate for the size, type, and risk characteristics of the institution's investments. The FCA expects each System institution to fully and carefully evaluate its risk tolerance in accordance with § 615.5133(c) when it considers purchasing any rural community investments. Finally, proposed § 615.5176(f) expressly exempts those rural community investments that System institutions classify and account for as held-to-maturity under generally accepted accounting principles from the securities valuation requirement in § 615.5133(f). This exemption is based on the different accounting classifications for these securities.

G. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FCA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that qualify them as small entities. Therefore, System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

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[1] 12 U.S.C. 2013(15) and 2122(13)(A).

[2] 12 U.S.C. 2073(10) and 2093(18).

[3]12 U.S.C. 2211. Section 4.25 authorizes System banks to organize service corporations. Section 4.28A of the Act, 12 U.S.C. 2214a, confers this authority on System associations.

[4]Section 4.25 of the Act prohibits service corporations from extending credit or providing insurance services to System borrowers. Otherwise, the Act authorizes service corporations to perform any other function or service that its FCS parents may perform. Service corporations currently have authority to purchase and hold other investments under FCA regulations in subpart E of part 615.

[5]Pub. L. No. 107-171, § 384J, 116 Stat. 134, 397 (May 13, 2002).

[6]The farmers' note program authorizes production credit associations and agricultural credit associations to invest in notes, contracts, and other obligations farmers and ranchers enter into with cooperatives and dealers that sell farm equipment, inputs, and supplies. Farmers' notes are investments that provide liquidity to small rural agribusinesses.

[7]Carol A. Jones, et al., "Population Dynamics Are Changing the Profile of Rural Areas," Amber Waves, Economic Research Service, United States Department of Agriculture, April 2007, p. 5.

[8]"Rural Education At A Glance," Rural Development Research Report Number 98, Economic Research Service, United States Department of Agriculture, November 2003, p. 4.

[9]Walter Gregg, The Availability and Use of Capital by Critical Access Hospitals, Flex Monitoring Team Briefing Paper No. 4, Flex Monitoring Team – University of Minnesota, University of North Carolina at Chapel Hill, and the University of Southern Maine, March 2005, p. 10.

[10]Ibid., p. 25 and 26.

[11]Ted Covey, et al., "Agricultural Income and Finance Outlook," Outlook, AIS-85, Economic Research Service, United States Department of Agriculture, December 2007, p. 49.

[12] "Chapter 3-Focus on Agriculture," Worker Health Chartbook 2004, National Institute for Occupational Safety and Health, NIOSH Publication No. 2004-146, p. 1.

[13]Sections 1.5(21), 2.2(20), 2.12(20) and 3.1(16) of the Farm Credit Act (12 U.S.C. 2013(21), 2073(20), 2093(20), 2122(16)).

[14]The United States Census Bureau defines an urbanized area as an urban area of 50,000 or more people that have core census block groups or blocks that have a population density of at least 1,000 people per square mile and surrounding census blocks that have an overall density of at least 500 people per square mile.

[15]Andrew F. Coburn et al., "Choosing Rural Definitions: Implications for Health Policy," Rural Policy Research Institute Health Panel, March 2007, p. 1.

[16]Ibid.

[17]According to section 3.7(f) of the Act, 12 U.S.C. 2128(f), banks for cooperatives and agricultural credit

banks may extend credit to water and waste disposal facilities in communities where the population does not exceed 20,000 inhabitants based on the latest decennial census of the United States. A provision of the Farm Security and Rural Investment Act of 2002, 7 U.S.C. 2009cc, et seq., authorizes System institutions to establish and invest in rural business investment companies in communities in non-metropolitan counties that have populations of 50,000 or less inhabitants under the last decennial census of the Unites States.

[18]Kendall McDaniel, "Venturing into Rural America," The Main Street Economist, Center for the Study of Rural America – Federal Reserve Bank of Kansas City, p. 2.

[19]Mark Drabenstott, et al., "Main Streets of Tomorrow: Growing and Financing Rural Entrepreneurs - A Conference Summary," Economic Review, Third Quarter 2003, Federal Reserve Bank of Kansas City, p. 73 and 74.

[20]Ibid.

[21]This amount is comparable to the regulatory limits established for the System's rural home lending and investments in farmers' notes activities, which are limited to amounts totaling $35.9 billion for each program as of year-end, although actual amounts outstanding under these programs represented 1.3 percent and less than 1 percent of total outstanding loans, respectively.

[22]12 U.S.C. 2073(10) and 2093(18).

List of Subjects in 12 CFR Part 615

Accounting, Agriculture, Banks, banking, Government securities, Investments, Rural areas.

For the reasons stated in the preamble, part 615 of chapter VI, title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 615--FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS, AND FUNDING OPERATIONS

1. The authority citation for part 615 is revised to read as follows:

Authority: Secs. 1.1, 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.3, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2001, 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b-6, 2279aa, 2279aa-3, 2279aa-4, 2279aa-6, 2279aa-7, 2279aa-8, 2279aa-10, 2279aa-12); 7 U.S.C 2009cc et seq.; sec. 301(a) of Pub. L. 100-233, 101 Stat. 1568, 1608.

Subpart F--Property, Transfers of Capital and Other Investments

2. A new § 615.5176 is added to subpart F to read as follows:

§ 615.5176 Rural community investments.

(a) *Rural communities.* As authorized by this section, each Farm Credit System (System) bank, association, or service corporation (hereafter "institution") may make rural community investments. All investments that any System institution makes under this section in rural communities must be outside an urbanized area as determined by the latest decennial census of the United States.

(b) *Debt securities.* Each institution may make investments in rural communities by purchasing and holding debt securities. For the purposes of this section, debt securities are obligations that are commonly recognized in the established capital markets as a medium for investment. Debt securities exclude commercial loans and any instrument or transaction that is more similar to a commercial loan than to a traditional investment instrument or transaction. Debt securities include government obligations, corporate debt obligations, revenue bonds, asset-backed securities, as defined by § 615.5131(a), and mortgage securities, as defined by § 615.5131(h). Debt securities that institutions purchase and hold under this section must provide funding in rural communities for:

(1) Essential community facilities such as hospitals, clinics, emergency services, and schools;

(2) Basic transportation infrastructure, such as roads, bridges, and other public transportation systems;

(3) Revitalization projects that rebuild rural areas recovering from disasters where an emergency has been declared pursuant to law;

(4) Rural development projects for which the issuer, sponsor, or provider of a guarantee is:

(i) The United States or any of its agencies, instrumentalities, or corporations, under programs that have the specific purpose of directly financing economic development in rural areas; or

(ii) Any State, the Commonwealth of Puerto Rico, local or municipal governments, or other political subdivisions.

(5) Non-System financial institutions for their activities that support rural development.

(c) *Equity investments.* System institutions may also make investments in:

(1) *Rural Business Investment Companies* that are established and operate in accordance with 7

U.S.C. 2009cc et seq.; or

(2) *Venture capital funds* that are established to promote economic development and job opportunities in businesses located in rural communities, so long as an institution does not:

(i) Invest more than 5 percent of its total surplus in venture capital funds and more than 2 percent of its total surplus in any one venture capital fund;

(ii) Hold more than 20 percent of the voting equity of any one venture capital fund;

(iii) Participate in the routine management or operation of any venture capital fund;

(iv) Allow any institution director, officer, or employee to serve as director, officer, employee, principal shareholder, or trustee of any venture capital fund, or of any entity funded by, or affiliated with any venture capital fund; or

(v) Participate in any decision or action of any venture capital fund involving or affecting any customer of the institution.

(d) *Other investments approved by the Farm Credit Administration*. System institutions may make other investments in rural communities that are not expressly authorized by this section if they are approved by the Farm Credit Administration. Written requests for Farm Credit Administration approval must describe the proposed project or program in detail, explain its risk characteristics, and demonstrate how such investments are consistent with the statutory mandate of the Farm Credit System.

(e) *Restrictions on rural community investments*.

(1) *Portfolio limit*. An institution must not invest more than 150 percent of its total surplus in rural community investments.

(2) *Obligor limit*. An institution must not invest more than 15 percent of its total surplus in rural community investments issued by any single entity, issuer, or obligor. This obligor limit does not apply to obligations of the United States or its agencies, instrumentalities, or corporations. An institution must count securities that it holds through an investment company towards the obligor limit of this section unless the investment company's holding of the securities of any one issuer does not exceed 5 percent of the investment company's total portfolio.

(3) *Maturities for debt securities*. Debt securities purchased by institutions under this section must mature in not more than 20 years, except that debt securities may mature in not more than 40 years if the United States or its agencies provide a guarantee or a conditional commitment of guarantee for 50 percent or more of the total issuance or obligation.

(4) *Exclusion from the liquidity reserve*. No Farm Credit bank shall include any investment made in accordance with this section in its liquidity reserve under § 615.5134 of this part.

(5) *Association investments*. A System association may hold rural community investments only with the approval of its funding bank. Each district Farm Credit bank must annually review all rural community investments held by its affiliated associations.

(6) *Attribution of service corporation investments*. All investments in rural communities that service corporations hold under this section must be attributed to their System institution parents based on the ownership percentage of each bank or association.

(f) *Management of rural community investments*. Before a System institution invests in rural communities, its board of directors must first adopt written policies for managing the institution's rural community investments. Investment management policies must be appropriate for the levels, types, and complexities of each institution's rural community investments. These written policies must comply with requirements of § 615.5133. Investments made under this section that System institutions classify and account for as held-to-maturity securities in accordance with generally accepted accounting principles are exempt from the requirements of paragraph (f) of § 615.5133. The board of directors must ensure that the institution implements procedures and internal controls to ensure compliance with the board’s policies and the regulation.

Dated: June 10, 2008

Roland Smith,
<u>Secretary</u>,
<u>Farm Credit Administration Board</u>.

75 FR 68533, 11/08/2010

Handbook Mailing HM-10-12

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AC25

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Capital Adequacy; Capital Components-–Basel Accord Tier 1 and Tier 2

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking (ANPRM); extension of comment period.

SUMMARY: The Farm Credit Administration (FCA, Agency or we) is extending the comment period on our ANPRM that seeks comments to facilitate the development of enhancements to our regulatory capital framework to more closely align minimum capital requirements with those of the Federal banking regulators and with risks taken by Farm Credit System (FCS or System) institutions, taking into consideration the System's public mission as a Government-sponsored enterprise (GSE) and its unique cooperative structure. We are extending the comment period so all interested parties will have additional time to provide comments.

DATES: You may send comments on or before May 4, 2011.

ADDRESSES: There are several methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the Agency's Web site. As facsimiles (faxes) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act (29 U.S.C. 794d), we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comments multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.

- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."

- Federal E-Rulemaking Web site: http://www.regulations.gov. Follow the instructions for submitting comments.

- Mail: Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Legal Info," and then select "Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Laurie Rea, Associate Director, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4232, TTY (703) 883-4434,

or

Chris Wilson, Financial Analyst, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4204, TTY (703) 883-4434,

or

Rebecca S. Orlich, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION: On July 8, 2010, FCA published a notice in the Federal Register seeking public comment to facilitate the development of a proposed rule that would minimize the differences, to the extent appropriate, in regulatory capital requirements between System institutions and Federally regulated banking organizations.[1]

The comment period is scheduled to expire on November 5, 2010. In a letter dated October 20, 2010, the Farm Credit Council (FCC), on behalf of the System including the Federal Farm Credit Banks Funding Corporation, requested that the Agency extend the comment period until February 28, 2011. The FCC requested the extension in order to give the System the opportunity to study the rules developed by the Federal banking regulators. The Basel Committee on Banking Supervision is in the process of formulating a new regulatory capital framework, and the U.S. banking regulators are expected to revise their capital guidelines consistent with the new requirements. In view of the expected revisions in the near future, the FCA has decided to extend the comment period 180 days beyond the original expiration date and, therefore, the comment period will close on May 4, 2011. The FCA supports public involvement and participation in its regulatory process and invites all interested parties to review and provide comments on our ANPRM.

Dated: November 4, 2010

Roland E. Smith,
Secretary,
Farm Credit Administration Board.

[1] See 75 FR 39392.

75 FR 39392, 07/08/2010

Handbook Mailing HM-10-7

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AC61

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Capital Adequacy; Capital Components—Basel Accord Tier 1 and Tier 2

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: The Farm Credit Administration (FCA or we) is considering the promulgation of Tier 1 and Tier 2 capital standards for Farm Credit System (FCS or System) institutions. The Tier 1/Tier 2 capital structure would be similar to the capital tiers delineated in the Basel Accord that the other Federal financial regulatory agencies have adopted for the banking organizations they regulate. We are seeking comments to facilitate the development of this regulatory capital framework, including new minimum risk-based and leverage ratio capital requirements that take into consideration both the System's cooperative structure of primarily wholesale banks owned by retail lender associations that are, in turn, owned by their member borrowers, and the System's status as a Government-sponsored enterprise.

DATES: You may send comments on or before November 5, 2010.

ADDRESSES: There are several methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (faxes) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act (29 U.S.C. 794d), we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal E-Rulemaking Web site: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Send mail to Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Laurie Rea, Associate Director, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4232, TTY (703) 883-4434,

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SUPPLEMENTARY INFORMATION:

I. Objective

The objective of this advance notice of proposed rulemaking (ANPRM) is to seek public comments to help us formulate proposed regulations that would:

1. Promote safe and sound banking practices and a prudent level of regulatory capital for System institutions;
2. Minimize differences, to the extent appropriate, in regulatory capital requirements between System institutions[1] and federally regulated banking organizations;[2]
3. Improve the transparency of System capital for System stockholders, investors, and the public; and
4. Foster economic growth in agriculture and rural America through the effective allocation of System capital.

II. Summary and List of Questions

A. Introduction

In October 2007, the FCA published an ANPRM on the risk weighting of assets — the denominator in our risk-based core surplus, total surplus, and permanent capital ratios; a possible leverage ratio, and a possible early intervention framework (October 2007 ANPRM).[3] The comment letter we received in December 2008 from the Federal Farm Credit Banks Funding Corporation on behalf of the System (System Comment Letter) focused primarily on the numerators of those regulatory capital ratios.[4] The System urged us to replace the core surplus and total surplus capital standards with a "Tier 1/Tier 2" capital framework consistent with the Basel Accord (Basel I) and the other Federal financial regulatory agencies' (FFRAs[5]) guidelines to help provide a level playing field for the System in competing with commercial banks in accessing the capital markets. Furthermore, the System recommended that we replace our net collateral ratio (NCR), which is applicable only to banks, with a non-risk-based leverage ratio applicable to all System institutions. We have responded to a number of issues and comments raised in the System Comment Letter in drafting this ANPRM.

Basel I is a two-tiered capital framework for measuring capital adequacy that was first published in 1988 by the Basel Committee on Banking Supervision.[6] Tier 1 capital, or core capital, consists of the highest quality capital elements that are permanent, stable, and immediately available to absorb losses and includes common stock, noncumulative perpetual stock, and retained earnings. Tier 2 capital, or supplementary capital, includes general loan-loss reserves, hybrid instruments such as cumulative stock and perpetual debt, and subordinated debt. Basel I established a minimum 4-percent Tier 1 risk-based capital ratio and an 8-percent total risk-based capital ratio (Tier 1 + Tier 2).

In December 2009, the Basel Committee published a consultative document (Basel Consultative Proposal) that proposes fundamental reforms to the current Tier 1/Tier 2 capital framework.[7] The Basel Committee's primary aims are to improve the banking sector's ability to absorb shocks arising from financial and economic stress, to mitigate spillover risk from the financial sector to the broader economy, and to increase bank transparency and disclosures. The Basel Committee intends to develop a set of new capital and liquidity standards by the end of 2010 to be phased in by the end of 2012. Although the FFRAs have discretion whether or not to adopt the new standards, they are members of the Basel Committee and have encouraged the public to review and comment on the Basel Committee's proposals. Consequently, we believe it is important for the FCA to consider the Basel Consultative Proposal in formulating new capital standards for System institutions, and we encourage commenters on our ANPRM also to review and consider the Basel Committee's proposals.

B. <u>The Farm Credit System</u>

The Farm Credit System (FCS or System) is a federally chartered network of borrower-owned lending cooperatives and related service organizations. Cooperatives are organizations that are owned and controlled by their members who use the cooperatives' products or services. The System was created by Congress in 1916 as a farm real estate lender and was the first Government-sponsored enterprise (GSE); in subsequent years, Congress expanded the System to include production credit, cooperative, rural housing, and other types of lending. The mission of the FCS is to provide sound and dependable credit to its member borrowers, who are American farmers, ranchers, producers or harvesters of aquatic products, their cooperatives, and certain farm-related businesses and rural utility cooperatives. The FCA is the System's independent Federal regulator that examines and regulates System institutions for safety and soundness and mission compliance. The System's enabling statute is the Farm Credit Act of 1971, as amended (Act).[8]

The System is composed of 88 associations that are direct retail lenders; four Farm Credit Banks that are primarily wholesale lenders to the associations; an Agricultural Credit Bank (CoBank, ACB) that makes retail loans to cooperatives as well as wholesale loans to associations; and a few service organizations.[9] Each System bank has a district, or lending territory, which includes the territories of the affiliated associations that it funds; CoBank, in addition, lends to cooperatives nationwide. There are currently two types of System association structures: Agricultural credit associations (ACAs) that are holding companies with subsidiary production credit associations (PCAs) and Federal land credit associations (FLCAs), and stand-alone FLCAs. PCAs make short- and intermediate-term operating or production or rural housing loans, and FLCAs make real estate mortgage loans and long-term rural housing loans. ACAs have the authorities of both PCAs and FLCAs.

The five banks collectively own the Federal Farm Credit Banks Funding Corporation (Funding Corporation), which is the fiscal agent for the System banks and is responsible for issuing and marketing Systemwide debt securities in domestic and global capital markets. The proceeds from the securities are used by the banks to fund their lending and other operations, and the banks are jointly and severally liable on the debt.

C. <u>The FCA's Current Capital Regulations</u>

The FCA currently has three risk-based minimum capital standards: A 3.5-percent core surplus ratio (CSR), a 7-percent total surplus ratio (TSR), and a 7-percent permanent capital ratio (PCR).[10] Congress added a definition of "permanent capital" to the Act in 1988 and required the FCA to adopt risk-based permanent capital standards for System institutions. The FCA adopted permanent capital regulations in 1988 and, in 1997, added core surplus and total surplus capital standards for banks and associations, as well as a non-risk-based net collateral ratio (NCR) for banks.[11] Since then, we have made only minor changes to these regulations.

Permanent capital is defined primarily by statute and includes current earnings, unallocated and allocated earnings, stock (other than stock retirable on repayment of the holder's loan or at the discretion of the holder, and certain stock issued before October 1988), surplus less allowance for losses, and other debt or equity instruments that the FCA determines appropriate to be considered permanent capital. Core surplus contains the highest quality capital, similar (but not identical) to Basel I's Tier 1 capital and generally consists of unallocated retained earnings, certain allocated surplus, and noncumulative perpetual preferred stock less, for associations, the association's net investment in its affiliated bank. Total surplus generally contains most of the components of permanent capital but excludes stock held by borrowers as a condition of obtaining a loan and certain other instruments that are routinely and frequently retired by institutions.

Section IV of this ANPRM provides more detailed information for readers who are not familiar with our regulatory capital requirements; the FCA's October 2007 ANPRM and comments; and Basel I and the Basel Consultative Proposal.

D. <u>List of Questions</u>

This ANPRM poses questions on the possible promulgation of regulatory capital standards based on Basel I and the FFRAs' guidelines while keeping in mind the reforms being proposed by the Basel Committee. It is tailored to account for the member-owner cooperative structure and GSE mission of the System. The questions are listed below and followed by a full discussion in Section III.

1. We seek comments on the different ways System banks and associations retain and distribute capital, how their borrowers influence the System institution's retention and distribution of capital, and how such differences should be captured in a new regulatory capital framework. Should we adopt separate and tailored regulatory capital standards for banks and associations? Why or why not?

2. We seek comments on ways to address bank and association interdependent relationships in the new regulatory capital framework. Should we establish an upper Tier 1 minimum standard for banks and associations? Why or why not? If so, what capital items should be included in upper Tier 1, and should bank requirements differ from association requirements?

3. We seek comments on ways to ensure that the majority of Tier 1 and total capital is retained earnings and capital held by or allocated to an institution's borrowers. Should we establish specific regulatory restrictions on third-party capital? Why or why not? If so, should there be different restrictions for banks and associations?

4. We seek comments on the role that permanent capital will play in a new regulatory capital framework. Should we replace any regulatory limits and/or restrictions based on permanent capital with a new limit based on Tier 1 or total capital? If so, what should the new limits and/or restrictions be? Also, we ask for comments on how, or whether, to reconcile the sum of Tier 1 and Tier 2 (e.g., total capital) with permanent capital.

5. We seek comments on other types of allocated surplus or stock in the System that could be considered unallocated retained earnings (URE) equivalents under a new regulatory capital framework. We ask commenters to explain how these other types of allocated surplus or stock are equivalent to URE.

6. We seek comments on ways to limit reliance on noncumulative perpetual preferred stock (NPPS) as a component included in Tier 1 capital while avoiding the downward spiral effect that can occur when other elements of Tier 1 capital decrease.

7. We seek comments to help us develop a capital regulatory mechanism that would allow System institutions to include allocated surplus and member stock in Tier 1 capital. Using the table titled "System Institutions Capital Distributions Restrictions and Reporting Requirements" as an example, what risk metrics would be appropriate to classify a System institution as Category 1, Category 2, or Category 3? What percentage ranges would be appropriate for each risk metric under each category? We also seek comments on the increased restrictions and/or reporting requirements listed in Category 2 and Category 3.

8. We seek comments on whether the FCA should count a portion of the allowance for loan losses (ALL) as regulatory capital. We also seek information on how losses for unfunded commitments equate to ALL and why they should be included as regulatory capital. We ask commenters to take into consideration the Basel Consultative Proposal and any recent changes to FFRA regulations in relation to the amount or percentage of ALL includible in Tier 2 capital.

9. We seek comments on the treatment of cumulative perpetual and term-preferred stock as Tier 2 capital subject to the same conditions imposed by the FFRAs.

10. We seek comments on authorizing System institutions to include a portion of unrealized holding gains on available-for-sale (AFS) equity securities as regulatory capital. We ask commenters to provide specific examples of how this component of Tier 2 capital would be applicable to System institutions.

11. We seek comments on the treatment of intermediate-term preferred stock and subordinated debt as Tier 2 capital and conditions for their inclusion in Tier 2 capital.

12. We seek comments on how to develop a regulatory mechanism to make a type of perpetual preferred stock that can be continually redeemed (referred to as H stock by most associations that have issued it) more permanent and stable so that the stock may qualify as Tier 2 capital.

13. We seek comments on the regulatory adjustments in our current regulations that we expect to incorporate into the new regulatory capital framework. We also seek comments on the regulatory capital treatment for positions in securitizations that are downgraded and are no longer eligible for the ratings-based approach under the new regulatory capital framework.

III. The Tier 1/Tier 2 Capital Framework Under Consideration by the FCA and Associated Questions

The table below displays the possible treatment of the System's capital components under a framework that is consistent with the FFRAs' current Tier 1/Tier 2 capital framework. We anticipate that the Basel Consultative Proposal could lead to significant changes to this framework, and we ask commenters to take the Basel Committee's proposals into consideration when answering the questions in this ANPRM.

Tier 1 Capital	
Capital Element	Comments
URE & URE Equivalents	We may create the term "URE equivalents" and ask commenters to help us identify types of allocated surplus and/or stock that would constitute URE equivalents.
Noncumulative Perpetual Preferred Stock (NPPS)	We may limit NPPS to an amount less than 50 percent of Tier 1 capital. We seek comments on ways to limit NPPS as Tier 1 capital while avoiding the downward spiral effect that can occur when other elements of Tier 1 capital decrease.
Allocated Surplus and Member Stock	We may treat most forms of allocated surplus and member stock as Tier 1 capital, provided System institutions are subject to a regulatory mechanism that would give the FCA the additional ability to effectively monitor and, if necessary, take actions that would restrict, suspend, or prohibit capital distributions before a System institution reaches its regulatory capital minimums. We ask commenters to help us develop this mechanism.
Tier 2 Capital	
Capital Element	Comments
Association's Excess Investment in the Bank	We may treat the amount of an association's investment that is in excess of its bank requirement, whether counted by the bank or the association, as Tier 2 capital.
Allowance for Loan Losses (ALL)	We have not determined whether any portion of ALL should be treated as Tier 2 capital. We seek comments as to why the FCA should count a portion of ALL as regulatory capital.
Cumulative Perpetual Preferred Stock and Long-Term Preferred Stock	We may adopt the definitions, criteria and/or limits consistent with future revisions to the Basel Accord and FFRA guidelines. We also may adopt aggregate third-party capital limits that are unique to the System.
Unrealized Holding Gains on AFS Securities	This element is currently addressed in the FFRAs' guidelines but is subject to change. We seek comment on the appropriate treatment of this element and specific examples of how this application would affect System institutions.
Intermediate-term Preferred Stock and Subordinated Debt	We may adopt the definitions, criteria and/or limits consistent with future revisions to the Basel Accord and FFRA guidelines. We also may adopt aggregate third-party capital limits that are unique to the System.
Association Continuously Redeemable Preferred Stock	We view this element as a 1-day term instrument that would not currently qualify as Tier 1 or Tier 2 capital. We seek comments to help us develop a regulatory mechanism that would make the stock sufficiently permanent to be included in Tier 2 capital.
Regulatory Adjustments	
We may apply most of the deductions currently in our regulations to the new regulatory capital ratios. However, in view of the Basel Consultative Proposal, we are considering reflecting the net effect of accumulated other comprehensive income in the new regulatory capital ratios.	

A. The Tier 1/Tier 2 Capital Structure within a Broader Context

1. Discussion of Bank and Association Differences

We established core surplus and total surplus standards in 1997 to ensure System institutions would have a more stable capital cushion that would provide some protection to System institutions, investors, and taxpayers; reduce the volatility of capital in relation to borrower stock retirements; and ensure that the institutions always maintain a sufficient amount of URE to absorb losses. Our determinations were influenced, in part, by what we learned in the 1980s when the System experienced severe financial problems.[12] At that time, the System was employing an average-cost pricing strategy that caused System loans to be priced below rates offered by other lenders when interest rates were high (e.g., in the early 1980s) and above rates offered by other lenders when interest rates fell (e.g., in the mid-1980s). When the System's rates were no longer competitive, many higher quality borrowers who could easily find credit elsewhere began to leave the System. Those who left early in the crisis were able to have the institution retire their stock at par, which at that time was around 5 to 10 percent of the loan (or some borrowers simply paid down their loans to an amount equal to their stock), causing capital and loan portfolio quality to drop sharply at many associations.

Some association boards had the legal discretion to suspend stock retirements but did not do so, perhaps to help their borrowers in times of distress but also to avoid sending a message to remaining and potential borrowers that borrower stock was risky. The result was that, in many cases, these actions left remaining stockholders bearing the brunt of more severe association losses. We concluded from these events that associations needed to build surplus cushions to be able to continue retiring borrower stock on a routine basis and to reduce the volatility associated with borrower stock retirements, and our 1997 regulations have effectively required associations to establish such cushions. System banks and associations retain and distribute capital differently. For this reason, we will consider whether to establish separate and tailored regulatory capital standards for banks and for associations as we construct a new regulatory capital framework.

System banks do not routinely retire their stock in the ordinary course of business or revolve surplus in the same manner as associations. At the present time, each bank has established a “required investment,”[13] which may consist of both purchased stock and allocated surplus, for each of its affiliated associations.[14] This required investment, which is generally a percentage of the association’s direct loan outstanding from the bank, can fluctuate within a bank board’s established range depending upon the bank’s capital needs. The bank’s bylaws usually require an association that falls short of the required investment to purchase additional stock in the bank.[15] In most cases, the banks make little distinction between purchased stock and allocated surplus.

Associations make a greater distinction between borrower stock and the surplus they allocate to borrowers.[16] Borrower stock held by retail borrowers as a condition of obtaining a loan is routinely retired by the association at par when the borrower pays off or pays down the loan. Some associations allocate earnings, and others do not. Some associations do not have allocated equity revolvement plans and distribute patronage only in the form of cash on an annual basis.[17] Other associations do not have allocated equity revolvement plans but distribute some patronage in the form of nonqualified or qualified allocated equities on a regular basis; they generally determine how such equity will be distributed on an ad hoc or annual basis after assessing market conditions. Still other associations have equity revolvement plans and distribute earnings as either cash or nonqualified or qualified allocated equities consistent with the plan; however, they have the power to withhold or suspend cash distributions to respond to changing economic and financial conditions.

The cooperative structure and operations of System associations are significantly different from a typical corporate structure in that a borrower's expectation of patronage distributions can and does influence the permanency and stability of association stock and allocated surplus. In addition, a System bank's retention and distribution of bank stock and bank surplus are different from those of associations for a number of reasons, including the tax implications and the fact that an association cannot easily find debt financing from sources other than the bank. We are asking commenters to consider the unique structure and practices of System banks and associations, the characteristics and expectations of their borrowers, and how such characteristics and expectations can impact the stability and permanency of stock and surplus.

Question 1: We seek comments on the different ways System banks and associations retain and distribute capital, how their borrowers influence the System institution's retention and distribution of capital, and how such differences should be captured in a new regulatory capital framework. Should we adopt separate and tailored regulatory capital standards for banks and associations? Why or why not?

2. Limits and Minimums

The current regulatory capital minimums imposed by the FFRAs include a 4-percent Tier 1 risk-based capital ratio, an 8-percent minimum total risk-based capital ratio with the amount of Tier 2 components limited to the amount of Tier 1, and a 4-percent minimum Tier 1 non-risk-based leverage ratio. These standards could change as a result of efforts to revise the risk-based capital ratios and introduce a non-risk-based leverage ratio that may integrate off-balance sheet items as outlined in the Basel Consultative Proposal. We are also considering an "upper Tier 1" minimum consistent with the Basel Committee's proposed common equity standard. An upper Tier 1 minimum would ensure that the predominant form of a System institution's Tier 1 capital consists of the highest quality capital elements. Finally, we are studying third-party capital limits that take into consideration the System's GSE charter and cooperative form of organization.[18] These limits and/or minimums for System banks may differ from the limits and minimums for associations.

a. Upper Tier 1 Minimum

Upper Tier 1 in a commercial banking context is typically referred to as "tangible common equity"; it is the highest quality portion of a commercial bank's Tier 1 capital and consists of common stockholder's equity and retained earnings. A commercial bank's upper Tier 1 capital, or tangible common equity, is the most permanent and stable capital available to absorb losses to ensure it continues as a going concern. The FRB's and FDIC's regulatory guidelines state that the dominant form of Tier 1 capital should consist of common stockholder's equity and retained earnings.[19] Upper Tier 1 in a System lending institution context would not necessarily have the equivalent components of tangible common equity at a commercial bank. The FCA's position has been that borrower stock and many forms of allocated surplus are generally less permanent, stable and available to absorb losses than URE and URE equivalents[20] because suspension of patronage distributions and stock retirements can have negative effects on the institution's relationship with its existing and prospective customers. We currently restrict all forms of allocated equities includible in core surplus to 2 percentage points[21] of the 3.5-percent CSR unless a System institution has at least 1.5 percent of uncommitted, unallocated surplus and noncumulative perpetual preferred stock.[22]

As noted above, the Basel Committee is considering establishing a new common equity standard[23] and has described the characteristics that instruments must have to qualify as common equity. Instruments such as member stock and surplus in cooperative financial institutions must also have these characteristics to be included in common equity. The FCA will take into account these characteristics as it considers an upper Tier 1 standard for System institutions.

We are also considering an upper Tier 1 minimum to address interdependency risk within the System. Because of their financial and operational interdependence, financial problems at one System institution can spread to other System institutions. An upper Tier 1 capital requirement could help moderate these interdependent relationships if it contains uncommitted, high quality, loss-absorbing capital that protects the investors of a System institution from its own financial problems as well as from the financial problems of other System institutions.

A commercial bank that needs additional upper Tier 1 capital may have the ability to issue additional common stock to investors without any direct impact on its customers. System institutions have fewer options to increase their highest quality capital, and exercising these options could have negative effects on their member borrowers in adverse situations. For example, if a System bank suffers severe losses and needs to replenish capital, its only options might be to reduce or suspend patronage distributions to its affiliated associations or to increase its associations' minimum required investments in the bank, or both. Since an association depends, to some extent, on the earnings distributions it receives from its bank, the association would have less income to purchase additional capital to support its struggling bank. The association might have to use its earnings from its own operations to recapitalize the bank instead of making cash patronage distributions to its borrowers or capitalizing new loans. The bank's financial weakness could spur the association to try to reaffiliate with another System bank; however, as the System Comment Letter points out,[24] associations cannot easily reaffiliate with another funding bank or voluntarily liquidate or terminate System status under a stressed bank financial scenario. A sufficient amount of upper Tier 1 capital at the bank that consists of unallocated capital would help cushion the bank losses that can negatively impact the associations and their borrowers. It would protect the association's investment and reduce the likelihood that the bank will raise the association's capital requirement at a time when the association is least able to afford it.

Upper Tier 1 requirements at associations would also protect the borrowers' investments in the institution. Associations with financial problems might not have additional capital to meet the bank's required investment, and the bank might, in turn, try to obtain additional capital from healthier associations to ensure the bank remains adequately capitalized. Because of these interdependent relationships, it is possible that weaker associations could pull down healthier associations. An adequate amount of upper Tier 1 capital at the associations would help protect the borrower's investment from losses resulting from these interdependent relationships.

If the FCA determines that borrower stock and allocated surplus can be treated in part or in whole as Tier 1 capital (depending upon appropriate regulatory mechanisms as discussed below), we may establish an upper Tier 1 minimum at both the banks and the associations to protect against systemic risks outside the control of the System institution. The upper Tier 1 requirement for System banks might be different from the requirement for associations. For example, an upper Tier 1 minimum at the banks might include only URE and URE equivalents to protect the associations' required investments in the bank. An upper Tier 1 minimum at the associations might include some forms of allocated surplus but exclude other forms of allocated surplus and most or all borrower stock.[25]

Question 2: We seek comments on ways to address bank and association interdependent relationships in the new regulatory capital framework. Should we establish an upper Tier 1 minimum for banks

and associations? Why or why not? If so, what capital items should be included in upper Tier 1, and should bank requirements differ from association requirements?

b. Third-Party Capital Limits

System institutions capitalize themselves primarily with member stock and surplus. System institutions are also authorized to raise capital from third-party investors who are not borrowers of the System. Third-party capital may include various kinds of hybrid capital instruments such as preferred stock and subordinated debt. While diverse sources of capital improve a System institution's risk-bearing capacity and, to a certain extent, improve corporate governance through increased market discipline, the FCA believes that too much third-party capital would compromise the cooperative nature and GSE status of the System. Consequently, we have imposed limits on the amount of third-party capital that is includible in a System institution's regulatory capital.[26]

The FCA agrees with the position of the Basel Committee that the predominant form of capital should be stable, permanent, and of the highest quality. While NPPS provides loss absorbency in a going concern, it absorbs losses only after member stock and surplus have been depleted. Since member stock and surplus rank junior to NPPS, it is more difficult for a System institution to raise additional capital from its patrons during periods of adversity if it holds a significant amount of NPPS. Furthermore, while dividends can be waived and do not accumulate to future periods, System bank issuers of NPPS, like commercial banks, appear to have strong economic incentives not to waive dividends since doing so would send adverse signals to the market.[27] Additionally, unlike customers of commercial banks, the customers of System institutions are impacted when System institutions are prohibited from paying patronage because they skipped dividends on preferred stock. For these reasons, we are considering maintaining limits on third-party capital in both Tier 1 and total capital to ensure that member stock and surplus remain the predominant form of System capital.[28]

Question 3: We seek comments on ways we can ensure that the majority of Tier 1 and total capital is retained earnings and capital held by or allocated to an institution's borrowers. Should we establish specific regulatory restrictions on third-party capital? Why or why not? If so, should there be different restrictions for banks and associations?

3. The Permanent Capital Standard

Permanent capital is defined by statute to include stock issued to System borrowers and others, allocated surplus, URE, and other types of debt or equity instruments that the FCA determines is appropriate to be considered permanent capital, but expressly excludes ALL.[29] The Act imposes a permanent capital requirement and, therefore, it will remain part of the System's regulatory capital framework. The FCA will continue to enforce any restrictions or other requirements prescribed in the Act relating to the permanent capital standard. (One such restriction prohibits a System institution from distributing patronage or paying dividends (with specific exceptions) or retiring stock if the institution fails to meet its minimum permanent capital standard.[30])

Several existing FCA regulations refer to measurements of permanent capital outstanding or PCR minimums.[31] For example, § 614.4351 sets a lending and leasing base for a System institution equal to the amount of the institution's permanent capital outstanding, with certain adjustments. Section 615.5270 permits a System institution's board of directors to delegate authority to management to retire stock as long as the PCR of the institution is in excess of 9 percent after any such retirements. Section 627.2710 sets forth the grounds for the appointment of a conservator or receiver for System institutions and defines a System institution as unsafe and unsound if its PCR is less than one half of the minimum required level (3.5 percent). We could retain these regulations in their current form, but it may be more appropriate to change any or all of them to fit the new regulatory capital framework.

Question 4: We seek comments on the role that permanent capital will play in the new regulatory capital framework. Should we replace any regulatory limits and/or restrictions based on permanent capital with a new limit based on Tier 1 or total capital? If so, what should the new limits and/or restrictions be? Also, we ask for comments on how, or whether, to reconcile the sum of Tier 1 and Tier 2 (e.g., total capital) with permanent capital.

B. The Individual Components of Tier 1 and Tier 2 Capital

1. Tier 1 Capital Components

We ask commenters to consider the Basel Consultative Proposal when addressing questions 5 through 7 below. The Basel Committee's proposed Tier 1 capital would include two basic components: Common equity (including current and retained earnings) and additional going-concern capital. Common equity must be the predominant form of Tier 1 capital. Common equity is, among other things, the highest quality of capital that represents the most subordinated claim in liquidation of a bank and takes the first and, proportionately, greatest share of losses as they occur. The instrument's principal must be perpetual, and the bank must do nothing to create an expectation at issuance that the instrument will be bought back, redeemed, or canceled. Additional going-concern capital is capital that is, among other things, subordinated to depositors and/or creditors, has fully discretionary noncumulative dividends or coupons, has no maturity date, and has no incentive to redeem.[32]

a. URE and URE Equivalents

URE is current and retained earnings not allocated as stock or distributed through patronage refunds or dividends. It is free from any specific ownership claim or expectation of allocation, it absorbs losses before other forms of surplus and stock, and it represents the most subordinated claim in liquidation of a System institution. The FCA expects to propose to treat URE as Tier 1 capital under the new regulatory capital framework.

URE equivalents are other forms of surplus that have the same or very similar characteristics of permanence (i.e., low expectation of redemption) and loss absorption as URE. For example, the System Comment Letter recommends treating association and bank nonqualified allocated surplus not subject to revolvement (NQNSR) as Tier 1 capital.[33] In the comment letter, the System characterizes NQNSR as allocated equity on which the institution is liable for taxes in the year of allocation and which the institution does not anticipate redeeming. In addition, the institution has not revolved NQNSR outside of the context of liquidation, termination, or dissolution. The System explains that the "member [is] aware that his ownership interest in the [institution] has increased such that, in the event of liquidation of the [institution], the member has a larger claim on the excess of assets over liabilities." The FCA will likely consider such NQNSR to be the equivalent of URE and expects to propose to treat it as Tier 1 capital under a new regulatory capital framework.

The System recommends that the FCA treat "Paid-In Capital Surplus" resulting from an acquisition in a business combination as Tier 1 capital. Current accounting guidance for business combinations under U.S. generally accepted accounting principles (U.S. GAAP)[34] requires the acquirer in a business combination to use the acquisition method of accounting. This accounting guidance applies to System institutions and became effective for all business combinations occurring on or after January 1,

2009. For transactions accounted for under the acquisition method, the acquirer must recognize assets acquired, the liabilities assumed and any non-controlling interest in the acquired business measured at their fair value at the acquisition date. For mutual entities such as System institutions, the acquirer must recognize the acquiree's net assets as a direct addition to capital or equity in its statement of financial position, not as an addition to retained earnings.[35]

The System provided the FCA with three examples of potential acquisitions under FASB guidance on business combinations. In each example, the retained earnings of the acquiree are transferred to the acquirer as Paid-In Capital Surplus.[36] Under these three scenarios, Paid-In Capital Surplus functions similarly to URE and would likely be treated as Tier 1 capital under a new regulatory capital framework. However, it is equally plausible that under other scenarios, as part of the terms of the acquisition, the acquirer might allocate some or all of the acquiree's retained earnings subject to some plan or practice of revolvement or retirement. Under such scenarios, the allocated portion may or may not qualify as Tier 1 capital. The FCA would likely look at the specific acquisition before determining whether the capital transferred in the acquisition would be Tier 1 or Tier 2 capital.

Question 5: We seek comments on other types of allocated surplus or stock in the System that could be considered URE equivalents under a new regulatory capital framework. We ask commenters to explain how these other types of allocated surplus or stock are equivalent to URE.

b. Noncumulative Perpetual Preferred Stock

NPPS is perpetual preferred stock that does not accumulate dividends from one dividend period to the next and has no maturity date. The noncumulative feature means that the System institution issuer has the option to skip dividends. Undeclared dividends are not carried over to subsequent dividend periods, they do not accumulate to future periods, and they do not represent a contingent claim on the System institution issuer. The perpetual feature means that the stock has no maturity date, cannot be redeemed at the option of the holder, and has no other provisions that will require future redemption of the issue.

The FFRAs treat some, but not all, forms of NPPS as Tier 1 capital. For example, the FRB emphasizes that NPPS with credit-sensitive dividend features generally would not qualify as Tier 1 capital.[37] The FDIC views certain NPPS where the dividend rate escalates excessively as having more in common with limited life preferred stock than with Tier 1 capital instruments.[38] Furthermore, the OCC, FRB, and FDIC do not include NPPS in Tier 1 capital if an issuer is required to pay dividends other than cash (e.g., stock) when cash dividends are not or cannot be paid, and the issuer does not have the option to waive or eliminate dividends.[39]

As noted above, the Basel Committee is proposing to establish a set of criteria for including "additional going-concern capital" such as NPPS in Tier 1 capital.[40] We will consider these criteria in a future proposed rulemaking.

Consistent with the Basel Committee's position, the FCA believes that high quality member stock and surplus should be the predominant form of Tier 1 capital. We are seeking comments on how to ensure that NPPS remains the minority of Tier 1 capital under most circumstances. We note that a specific limit on the amount of NPPS that is includible in Tier 1 capital may create a downward spiral effect in adverse situations where decreases in high quality member stock and surplus also decrease the amount of NPPS includible in Tier 1 capital.

One option would be to establish a hard limit that is something less than 50 percent of Tier 1 capital at the time of issuance. If this limit is subsequently breached due to adverse circumstances, the System institution would be required to submit a capital restoration plan to the FCA that includes increasing surplus through earnings in order to bring the percentage of NPPS in Tier 1 capital back below the limit that is imposed at the time of issuance. During such adversity, the System institution may be limited in its ability to issue additional NPPS that would qualify for Tier 1 regulatory capital treatment.

<u>Question 6: We seek comments on ways to limit reliance on NPPS as a component of Tier 1 capital while avoiding the downward spiral effect that can occur in adverse situations as described above.</u>

c. <u>Allocated Surplus and Member Stock</u>

i. <u>Overview of System Bank and Association Allocated Surplus and Member Stock</u>

Each System bank provides its affiliated associations with a line of credit, referred to as a direct note, as the primary source of funding their operations. Each association, in turn, is required to purchase a minimum amount of equity in its affiliated bank. This required investment minimum is generally a percentage of its direct note outstanding.[41] For example, suppose a bank that has a required investment range of 2 percent to 6 percent, as set forth in its bylaws, establishes a current required investment minimum of 3 percent of an association's direct note outstanding.[42] If the association falls short of the 3-percent minimum, it would be required to purchase additional stock in the bank. If the association's investment is over the 3-percent minimum, the bank would distribute (sometimes over a long period of time through a revolvement plan) or allot, for regulatory capital purposes, the "excess investment" back to the association.

CoBank, ACB makes direct loans to System associations and is also a retail lender to agricultural cooperatives, rural energy, communications and water companies and other eligible entities. CoBank builds equity for its retail business using a "target equity level" that is similar to the required investment minimum described above.[43] The target equity level includes the statutory minimum initial borrower investment of $1,000 or 2 percent of the loan amount, whichever is less,[44] and equity that is built up over time through patronage distributions. The CoBank board annually determines an appropriate targeted equity level based on economic capital and strategic needs, internal capital ratio targets, financial and economic conditions, market expectations and other factors. CoBank does not automatically or immediately pay off the borrower's stock after the loan is paid in full. Rather, it retires the stock over a long period of time.[45]

Borrowers from System associations are statutorily required to purchase association stock as a condition of obtaining a loan. The purchase requirement is set by the association's board and, by statute, must be at least $1,000 or 2 percent of the loan amount, whichever is less. In practice over the past two decades, association boards have set the member stock (or participation certificates for individuals or entities that cannot hold voting stock) purchase requirement at the statutory minimum and routinely retire the purchased stock when the borrower pays off his or her loan.[46] Consequently, the borrower has a high expectation of stock retirement when his or her loan is paid off. Currently, member stock is not includible in core surplus or total surplus and makes up only a small portion of the association's capital base.

The majority of an association's regulatory capital base comes through retained earnings as either allocated surplus or URE. Allocated surplus is earnings that are distributed as patronage to an individual borrower but retained by the association as part of the member's equity in the institution. We do not consider allocated surplus that is subject to revolvement to be a URE equivalent, because the borrower has an expectation of distribution at some future point in time through a System association's equity revolvement program. These revolvement programs vary depending upon the unique circumstances of the association. Currently, allocated surplus that is subject to revolvement is a small part of the capital base of most associations.

ii. The System Comment Letter and FCA's Responses to Treating Allocated Surplus and Member Stock as Tier 1 Capital

The System Comment Letter recommends that all at-risk allocated surplus and member stock be Tier 1 capital. We have categorized the System's comments into broad arguments. We respond below after each broad argument.

The System's first argument is that various systems and agreements are in place to ensure the stability and permanency of allocated surplus and borrower stock. For example, while a regular practice or plan of retirement may give rise to an expectation of equity retirement, borrowers do not have the legal right to demand retirement. A System institution board has the sole discretion to suspend or stop equity distributions at any time if warranted by changing economic and financial conditions. Moreover, an institution's bylaws and capital plans put some restraints on capital distributions under certain conditions. The System also comments that the System banks and the Funding Corporation have entered into a Contractual Interbank Performance Agreement and a Market Access Agreement, which provide early and quick enforcement triggers to protect against a bank's weakening capital position. In addition, each bank has a General Financing Agreement (GFA) with its affiliated associations. The GFA requires each association to maintain a satisfactory borrowing base, which is a measure of capital adequacy. Third-party capital issuances (e.g., preferred stock and subordinated debt) have terms that prohibit the payment of outsized cash patronage dividends and stock retirements if regulatory capital ratios are breached.

In our 1997 final rule on System regulatory capital, we addressed similar arguments and observed that internal systems and agreements alone do not ensure that System institutions consistently maintain sufficient amounts of high quality capital.[47] At the time, we decided to exclude member stock from core surplus and limit the inclusion of allocated surplus to ensure that System institutions had an adequate amount of uncommitted, unallocated surplus that was not at risk at another institution and not subject to borrower expectations of retirement or revolvement. However, as we discuss below, in developing the new regulatory capital framework, the FCA is considering what regulatory mechanisms could be put into place to make allocated surplus and member stock more permanent and stable so as to qualify as Tier 1 capital.

The System's second argument is that other banking organizations can treat similar equities as Tier 1 capital. For example, a Federal Home Loan Bank (FHLB) is permitted to include as "permanent capital" certain stock issued to commercial banks that is redeemable in cash 5 years after a commercial bank provides written notice to its FHLB.[48] In addition, Subchapter S commercial bank corporation (Subchapter S corporation) investors have expectations of regular dividend distributions that are similar to those of System borrowers, and FFRAs permit Subchapter S corporations to treat their equities as Tier 1 capital.[49]

In response to the second argument, while the FHLBs are not directly comparable to System institutions, we are open to suggestions on how to apply a 5-year or other time horizon to allocated surplus and member stock retirements. We note, however, that the inclusion of such stock in a FHLB's capital is mandated by statute and was not a safety and soundness determination made by the FHLB's regulator.[50] As for Subchapter S corporation investors, while they may have expectations of equity distributions that may be similar to those of System borrowers, Subchapter S corporations do not depend on their investors to make up the customer base of the institution. Consequently, the borrowers' influence on the System institution's retention and distribution of its stock and surplus may be different from the investors' influence on Subchapter S corporation's retention and distribution of its stock and surplus.

The System's third argument is that no distinction should be made between allocated surplus and URE based on cooperative principles. The System believes that cooperatives should be funded to the extent possible by current patrons on the basis of patronage. The System asserts that, if we require the majority of Tier 1 capital to be URE, the burden of capitalizing the institution is borne disproportionately by patrons who have repaid their loans and have ceased to use the credit services of the institution. The result is that current patrons enjoy the benefit the URE affords without bearing a substantial part of the burden of accumulating it. The System also contends that, from a tax perspective, retention of earnings as allocated surplus is a more efficient and less costly method of capital accumulation than URE. The single tax treatment under Subchapter T enables the cooperative to capitalize its operations from retention of patronage-sourced earnings and allows such earnings to be returned to its members without additional taxation. The result is that more of the earnings derived from the patron can be utilized to capitalize the cooperative's business at a lesser cost over time to the member. The System also states its belief that limits and/or exclusions of allocated surplus from Tier 1 capital would arbitrarily discourage System institutions from operating on a cooperative basis, unduly devalue allocated surplus, and prevent System institutions from maximizing non-cash patronage distributions as a component of capital management. The investment that borrowers hold in the institution would tend to remain relatively small, and without a material ownership stake in the institution, members are more likely to become disengaged from the processes of corporate governance and their crucial role in holding boards of directors accountable for poor performance. The System believes that the FCA should include all allocated surplus as Tier 1 capital.

In response to this third argument, we agree with the System that it is important to consider cooperative principles in developing the new regulatory capital framework. However, as noted above, allocated surplus that is regularly revolved is less stable and permanent than URE because of the borrower's reasonable expectation of equity distributions. In the current regulatory capital framework, we have striven to balance cooperative principles with FCA's safety and soundness objectives by treating only certain longer-term allocated equities as core surplus and requiring that at least 1.5 percent of core surplus be composed of elements other than allocated surplus. We continue to believe that certain regulatory mechanisms are needed to ensure that allocated equities subject to revolvement qualify as Tier 1 capital. We are willing to consider approaches other than time element restrictions. Association capital retention and distribution practices have changed over time and will continue to evolve. Our regulations should be flexible enough to encompass the myriad of institutions' revolvement plans without unduly hindering patronage distribution practices.

Five System associations also submitted individual comments recommending the FCA treat all association allocated surplus as Tier 1 capital. The five commenters assert that borrower expectations of patronage distributions have little or no effect on the stability and permanency of allocated surplus. In summary, they state that extensions of established revolvement cycles or reductions or suspensions of patronage distributions have not had a negative effect on marketing efforts, growth, or income at their associations. The associations state that they price their loans to market and provide high quality service, and they say there is little or no pressure from borrowers when scheduled patronage distributions are suspended or withheld.

While borrower expectations of patronage distributions do not appear to have had a material effect on the stability and permanency of allocated surplus under current conditions, we are not certain that this would be the case under other scenarios. Since 1997, from the time core surplus and total surplus requirements were established, the System has, for the most part, enjoyed strong growth and earnings as a result of favorable agricultural and wider macroeconomic conditions. Only recently have System institutions had to extend or suspend revolvement periods for allocations and reduce cash payments in response to the current economic downturn. Prior to this downturn, System institutions have not had recent experience with the trough of a credit cycle where very adverse credit conditions require boards to make hard decisions. Consequently, it is difficult to evaluate the efficacy of our capital requirements in times of severe stress.

Currently, the predominant form of System association capital is URE. Most associations distribute the majority of their patronage in cash. Consequently, most borrowers do not have a significant amount of direct ownership in the form of allocated surplus in their respective associations. However, it is possible that the associations could at some future point be primarily capitalized by their current patrons, and the majority of the association's capital base could be allocated surplus that is subject to regular revolvement. The borrower's direct capital investment would probably have to be significantly higher, and distributions that come from scheduled revolvement plans could be large and could possibly be material to a borrower's cash flows. Under this scenario, associations could have more difficulty suspending or withholding patronage distributions during periods of adversity, especially if the borrowers are stressed and are depending on scheduled patronage distributions to meet maturing financial obligations or to remain solvent. This possible scenario is the reason why the FCA's existing regulations require associations to hold a minimum amount of URE and other high quality equity that is not allocated equity. URE provides a capital cushion that enables the association to continue making routine borrower stock retirements as well as orderly planned distributions, which are especially important in situations where borrowers need those distributions to meet their own financial obligations.

The System Comment Letter asserts that association borrower stock should be treated as Tier 1 capital, pointing out that, while association borrower stock is commonly retired in conjunction with loan pay-offs, such retirement is always at risk and subject to association board discretion. Moreover, association boards commonly delegate to management and/or approve ongoing retirement programs only as long as such actions do not compromise the associations' capital adequacy. Finally, the System notes that borrower stock is of nominal amounts.

The FCA believes that, under the current regulatory framework, there is an important difference between borrower stock issued by associations and common stock issued by commercial banks. The investors who purchase an association's borrower stock are also customers of the association, whereas investors who purchase commercial bank common stock generally are not customers of the commercial bank. This customer/investor relationship of System borrowers to their associations makes borrower stock intrinsically different from commercial bank common stock. Since associations routinely retire borrower stock, suspension of stock retirements can have negative effects on the association's relationships with its customers, prospective customers, and its investors. The effect of a suspension of stock retirements may not be material today because borrower stock is presently nominal in amount, but stock retirements can become an issue when borrower stock makes up a larger portion of association capital. For instance, if associations increased their stock purchase requirement to 5 percent or 10 percent of the loan amount (as was the case up until the end of the 1980s) and then suspended the retirements, the borrowers would be more likely to be materially affected. In addition, the suspension of such stock retirements could undermine an association's efforts to attract new borrowers.

Second, borrower stock is routinely retired when the borrower pays off his or her loan. Commercial bank common stock is rarely retired once it is issued and generally requires notice to or the prior approval of the regulator.[51] The stock may trade among investors, but an individual shareholder would have little or no success in demanding that the commercial bank retire its stock in the absence of a retirement or exchange affecting the entire class of stock. In addition, commercial bank stock buy-backs are not analogous to stock retirements in connection with the paying off of loans and are not "routine" in the way association borrower stock retirements are routine.

Third, System borrowers generally do not pay cash for association stock. Rather, the par value of the stock is added to the principal amount of a borrower's obligation, and the association retains a first lien on the stock. From a practical standpoint, the borrower could simply pay down a loan to the par value of the stock and cease making any further payments. In such cases, it is usually easier and less costly for the association simply to offset the amount of the stock against the remaining loan balance than it is to take other legal measures (such as foreclosure) against a borrower. By contrast, commercial bank investors pay cash for their stock. Since their stock must be paid in full, the stockholder has no easy opportunity to use the stock to offset a debt obligation.

The System has also commented that association allocated surplus and borrower stock are equivalent in permanency and stability and should be treated the same way under the new regulatory framework. The System states that both types of equities are at risk and can be redeemed only at the discretion of the association's board and also claims that no distinction is made from the borrower's perspective. As we have explained throughout this ANPRM, we believe a distinction can be made from a safety and soundness perspective. The very fact that association borrower stock is routinely retired when a borrower pays off a loan makes borrower stock less permanent and stable than any form of surplus.

iii. <u>FCA's Consideration of a Proposal to Treat Allocated Surplus and Member Stock as Tier 1 Capital</u>

After evaluating the comments above, the FCA has begun to formulate a regulatory mechanism that would permit: 1) System associations to treat their allocated equities subject to revolvement and borrower stock as Tier 1 capital, 2) System banks to treat their associations' required minimum investment as Tier 1 capital, and 3) CoBank to treat its retail customers' stock and surplus as Tier 1 capital. This program would give us the ability to monitor, and if necessary, take actions that would restrict, suspend or prohibit capital distributions before a System institution reaches its regulatory capital minimums. An objective of the program would be to ensure that the FCA has some control over a System institution's capital distributions when it begins to experience financial stress. In this way, we believe that allocated surplus and member stock could qualify as Tier 1 capital.

The regulatory mechanism we may propose would operate differently from the FFRAs' Prompt Corrective Action framework.[52] The Prompt Corrective Action framework was designed, in part, to protect the Federal deposit insurance fund by requiring the FFRAs to take specific corrective actions against depository institutions as soon as they fall below minimum capital standards. In contrast, the purpose of our program would be to ensure the quality, permanence and stability of allocated surplus and member stock.

Because the Prompt Corrective Action framework relies almost exclusively on regulatory capital ratios, most corrective actions are not triggered until a depository institution falls below regulatory minimum capital requirements. The program we are considering proposing would have trigger points well above regulatory capital minimum requirements that, when breached, would require System institutions to take certain actions. We also expect to include other financial measures along with the capital ratios in the program to provide earlier indicators to a System institution's financial condition and performance.

The regulatory mechanism we may propose would conceivably incorporate many of the Treasury's principles for reforming regulatory capital frameworks.[53] For example, the Treasury has noted that the capital ratios in the Prompt Corrective Action framework have often acted as lagging indicators of financial distress and "ha[ve] resulted in far too many banking firms going from well-capitalized status directly to failure." The Treasury has recommended that the FFRAs consider improving their Prompt Corrective Action frameworks by adding supplemental triggers such as measures of non-performing loans or liquidity measures.

We also note that the Prompt Corrective Action framework is mandated for all depository institutions regulated by the FFRAs. The capital regulatory mechanism we are developing would apply only to those System institutions that elect to treat their allocated surplus and/or member stock as Tier 1 capital. System institutions that choose not to participate in the regulatory program would treat their allocated surplus and/or member stock as Tier 2 capital. The following chart sets forth the broad parameters of the program we are considering:

System Institution Capital Distribution Restrictions and Reporting Requirements

System Institution Category	Risk Metrics* (e.g. capital, asset, and liquidity metrics)	Regulatory Requirements (e.g., periodic reporting, prior approval on distributions, etc.)
Category 1	Capital Ratios = high Asset Quality = strong Asset Growth = low Liquidity = high	No additional requirements
Category 2	Capital Ratios = adequate Asset Quality = fair Asset Growth = high Liquidity = adequate	Notification to FCA of any capital distributions at least 30 days before declaration of distribution Institution must report all capital ratios to the FCA on a monthly basis and explain how asset quality, asset growth and liquidity have impacted the ratios
Category 3	Capital Ratios = low Asset Quality = poor Asset Growth = high Liquidity = low	FCA prior approval of any capital distributions Possible restrictions on capital distributions** Reporting requirements of Category 2, and the FCA may increase the scope and intensity of a specific institution-related issue on more than a monthly basis
The Capital Ratio thresholds for Category 3 would be the Regulatory Capital Minimums.		
If a System institution does not meet one or more of the regulatory minimum capital requirements, the FCA could take one or more supervisory actions under its existing authorities, such as conditions imposed in writing on transactions that require FCA approval; requiring a capital restoration plan; issuing supervisory letters, cease and desist orders, or capital directives; or placing the institution in conservatorship or receivership when there are grounds for doing so.		

* After the proposed capital distribution.

** This includes potential restrictions on patronage distributions, dividends, stock retirements, callable debt, and interest payments on third-party capital instruments.

The table above outlining the program we are considering displays categories we might use to determine whether or when to restrict or prohibit a System institution's capital distributions. Each participating System institution that has capital levels at or above the regulatory minimums would be assigned to one of three categories (e.g., the best performing System institutions would be assigned to Category 1 and so forth). FCA would place institutions in categories based on a variety of measures of capital adequacy, asset quality, asset growth and liquidity. These measures would have specific thresholds that would act as trigger points to require additional reporting or other action by the institution. Taken as a whole, the regulatory mechanism we are considering would assist the FCA in determining whether or when to intervene to limit or prevent a System institution's capital distributions in order to ensure the permanence and loss absorption capacity of allocated surplus and member stock.

The capital ratios we expect to use would include a Tier 1 risk-based capital ratio, a total (Tier 1 + Tier 2) risk-based capital ratio, and a Tier 1 non-risk-based leverage ratio. We are also considering a Tier 1 risk-based capital ratio or Tier 1 non-risked-based leverage ratio that includes the effects of other comprehensive income.[54] Minimum category 1 capital ratio thresholds would significantly exceed the new regulatory minimum capital requirements. Minimum category 2 capital ratio thresholds would exceed the new regulatory minimum capital requirements. Minimum category 3 capital ratio thresholds would be equal to the regulatory minimum capital requirements. For a System institution that does not meet at least one of the regulatory minimum capital requirements, the FCA could take one or more supervisory actions under our existing supervisory and enforcement authorities. As noted above, we also expect to use other financial ratios in conjunction with the regulatory capital ratios to provide earlier indicators of a System institution's financial condition and performance. We ask commenters to help us determine these other ratios and develop the thresholds.

The financial measures of the regulatory mechanism would need to reflect accurately a System institution's financial position and have appropriate thresholds to trigger a regulatory requirement so that the FCA can monitor and/or intervene to restrict capital distributions in a timely manner. For example, if a System institution dropped to Category 2, it would have to submit additional information to the FCA each month and give us prior notification of any capital distributions (as described in the table above). We are also considering requiring Category 2 institutions to submit a capital restoration plan. If a System institution drops to Category 3, it would need the FCA's prior approval of any capital distributions.[55]

Finally, the FCA would reserve the right to place a System institution in a different category if warranted by the particular circumstances of the institution and the current economic environment. We would monitor this program primarily through our examination function.

Question 7: We seek comments to help us develop a capital regulatory mechanism that would allow System institutions to include allocated surplus and member stock in Tier 1 capital. Using the table titled "System Institutions Capital Distributions Restrictions and Reporting Requirements" as an example, what risk metrics would be appropriate to classify a System institution as Category 1, Category 2, or Category 3? What percentage ranges of specific financial ratios would be appropriate for each risk metric under each category? We also seek comments on the increased restrictions and/or reporting requirements listed in Category 2 and Category 3.

2. Tier 2 Capital Components

As aforementioned, the Basel Committee is proposing changes, and we ask commenters to consider the changes to Tier 2 capital when responding to questions 8 through 12 below. At a minimum, the Basel Committee is proposing that Tier 2 capital be subordinated to depositors and general creditors and have a maturity of at least 5 years; recognition in regulatory capital will be amortized on a straight line basis during the final 5 years of maturity.[56]

a. The Association's Investment in the Bank

As explained above, each System association must maintain a minimum investment in its affiliated bank. The required investment is generally a percentage of the association's direct loan from the bank and may consist of both purchased stock and allocated surplus. If an association falls short of the required investment, it is generally required to purchase additional stock in the bank. Many associations have investments in their banks that are in excess of the bank's requirements.

Under our current capital regulations, an association's investment in its bank may be counted in whole or in part in either the bank's total surplus and permanent capital, or in the association's total surplus and permanent capital, but it may not count in both institutions' regulatory capital. This avoids the "double-duty" dollar situation of using the same dollar of capital to support risk-bearing capacity at both institutions. A capital allotment agreement between a System bank and a System association specifies which of the institutions will include the investment in its regulatory capital.[57] Even though the association is permitted to include part or all of its investment in the bank in its permanent capital and total surplus, the association's investment is retained at the bank, at risk at the bank, included on the bank's balance sheet, and retired only at the discretion of the bank board. Moreover, if the bank were to fail or to be required to make payments under its statutory joint and several liability,[58] the association might lose part or all of its investment.

One System institution commenter recommended that the FCA treat an association's investment in the bank in excess of the minimum required investment, whether counted at the bank or the association, as Tier 1 capital. The commenter stated that the capital allotment agreement reflects a shared understanding between the System bank and System association that the excess amount allotted to the association is "owned" by the association and should not be leveraged by the bank. While the commenter provides many arguments as to why the excess investment is regulatory capital, in our view the excess investment does not have the attributes of Tier 1 capital at the association level. As the commenter points out, the association cannot legally compel the bank to retire the stock or otherwise liquidate it to pay down the association's debt at a moment's notice, and the bank board retains the sole discretion as to when the stock can be retired.

b. Allowance for Loan Losses

Section 621.5(a) of our regulations requires System institutions to maintain ALL in accordance with GAAP. ALL must be adequate to absorb all probable and estimable losses that may reasonably be expected to exist in a System institution's loan portfolio. ALL is expressly excluded from the statutory definition of permanent capital in the Act Section 4.3A(a)(1)(C) of the Act[59] and will continue to be excluded from the permanent capital standard. The FCA does not currently treat any portion of ALL as either core surplus or total surplus.

Basel I defines ALL (referred to as general loan loss reserves) as reserves created against the possibility of losses not yet identified. The FFRAs, in general, define ALL as reserves to absorb future losses on loans and lease receivables. Currently, ALL can be included in Tier 2 capital up to 1.25 percent [60] of a banking organization's risk-adjusted asset base provided the institution is subject to capital rules that are based on either Basel I or the Basel II standardized approach.[61] Provisions or reserves that have been created against identified losses are not included in Tier 2 capital. Any excess amount of ALL may be deducted from the net sum of risk-weighted assets in computing the denominator of the risk-based capital ratio.

In the System Comment Letter, the System recommended that the FCA include ALL, including reserves for losses on unfunded commitments, as Tier 2 capital under the new regulatory capital framework consistent with the Basel I standards and FFRA guidelines. The FCA acknowledges that ALL is a front line defense for absorbing credit losses before capital but also believes that it may not be as loss absorbing as other components of capital because it is tied only to credit-related losses.

Question 8: We seek comments on whether the FCA should count a portion of the allowance for loan losses (ALL) as regulatory capital. We also seek information on how losses for unfunded commitments equate to ALL and why they should be included as regulatory capital. We ask commenters to take into consideration the Basel Consultative Proposal and any recent changes to FFRA regulations in relation to the amount or percentage of ALL includible in Tier 2 capital.

c. Cumulative Perpetual and Long-Term Preferred Stock

Cumulative perpetual preferred stock is preferred stock that accumulates dividends from one dividend period to the next but has no maturity date and cannot be redeemed at the option of the holder. Basel I and the FFRAs currently treat cumulative perpetual preferred stock as Tier 2 capital without limit (other than the general limitation that Tier 2 capital cannot exceed 100 percent of Tier 1 capital). The FCA expects to consider cumulative perpetual preferred stock as Tier 2 capital, provided the instrument does not have a significant step-up (as defined in Basel I) that has the practical effect of a maturity date.[62]

FCA regulations do not currently distinguish between long-term and intermediate-term preferred stock.[63] The FFRAs define long-term preferred stock as preferred stock with an original maturity of 20 years or more. Long-term preferred stock is Tier 2 capital subject to the same aggregate limits as cumulative perpetual preferred stock. In addition, the amount of long-term preferred stock that is eligible to be included as Tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) at the beginning of each of the last 5 years of the life of the instrument. The FCA is considering adopting the FFRAs' definition of long-term preferred stock and treating it as Tier 2 capital with similar conditions.

Question 9: We seek comments on the treatment of cumulative perpetual and term-preferred stock as Tier 2 capital subject to the same conditions imposed by the FFRAs.

d. Unrealized Holding Gains on Available-For-Sale (AFS) Equity Securities

The FCA does not currently treat any portion of a System institution's unrealized holding gains on AFS equity securities as regulatory capital. The FFRAs began treating unrealized holding gains on AFS equity securities as regulatory capital after the implementation of SFAS No. 115, which requires institutions to fair-value their AFS equity securities and reflect any changes in accumulated other comprehensive income as a separate component of equity capital.[64] This is comparable to Basel I treatment, which includes "revaluation reserves" in Tier 2 capital provided the reserves are revalued at their current value rather than at historic cost.

Basel I specifies that a bank must discount any unrealized gains by 55 percent to reflect the potential volatility of this form of unrealized capital, as well as the tax liability charges that would generally be incurred if the unrealized gains were realized. Consequently, the FFRAs treat up to 45 percent of the pretax net unrealized holding gains on AFS equity securities with readily determinable fair values as Tier 2 capital. Unrealized gains on other types of assets, such as bank premises and AFS debt securities, are not included in Tier 2 capital, though the FFRAs may take these unrealized gains into consideration when assessing a bank's overall capital adequacy. In addition, the FFRAs' guidelines reserve the right to exclude all or a portion of unrealized gains from Tier 2 capital if they determine that the equity securities are not prudently valued.[65]

It is important to note that Basel I and the FFRAs' guidelines require all unrealized losses on AFS equity securities to be deducted from Tier 1 capital.

Question 10: We seek comments on authorizing System institutions to include a portion of unrealized holding gains on AFS equity securities as regulatory capital. We ask commenters to provide specific examples of how this component of Tier 2 capital would be applicable to System institutions.

e. Intermediate-Term Preferred Stock and Subordinated Debt

The FFRAs define intermediate-term preferred stock as preferred stock with an original maturity of at least 5 years but less than 20 years. Subordinated debt is generally defined as debt that is lower in priority than other debt to claims on assets or earnings. The FCA currently treats subordinated debt as regulatory capital provided it meets certain criteria.[66]

Intermediate-term preferred stock and subordinated debt are currently considered to be "lower Tier 2" capital by the FFRAs and are limited to an amount not to exceed 50 percent of Tier 1 capital after deductions. In addition, the amount of intermediate-term preferred stock and subordinated debt that is eligible to be included as Tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) at the beginning of each of the last 5 years of the life of the instrument. The Basel Consultative Proposal indicates that the Basel Committee may remove the limits on how much of these components may count as Tier 2 capital, but the phase-out period will be retained. The FCA is considering treating intermediate-term preferred stock and subordinated debt as Tier 2 capital with an aggregate limit of 50 percent of Tier 1 capital after deductions consistent with FFRA regulations.

Question 11: We seek comments on the treatment of intermediate-term preferred stock and subordinated debt as Tier 2 capital and conditions for their inclusion in Tier 2 capital.

f. Association-Issued Continuously Redeemable Cumulative Perpetual Preferred Stock

Some associations have issued continuously redeemable cumulative perpetual preferred stock (designated as H Stock by most associations) to existing borrowers to invest and participate in their cooperative beyond the minimum borrower stock purchases. H Stock is an "at-risk" investment and can be redeemed only at the discretion of the association's board. H Stock has some similarity to a deposit or money market account in operation, but holders of H Stock do not have an enforceable right to demand payment. The FCA has previously determined that H Stock qualifies as permanent capital because it is at risk and is redeemable solely at the discretion of the association's board. However, the H Stock is not includible in core surplus or total surplus because of the association's announced intention to redeem the stock upon the request of the holder, provided minimum regulatory capital ratios are met.

The System Comment Letter recommends treating H stock as Tier 2 capital because of its temporary nature. The System states that disclaimers inform H Stock stockholders that retirement is subordinate to debt instruments and subject to board discretion. However, the holders have a high expectation that such stock will be retired. Also, the members' investment horizons are relatively short; so the capital would be viewed as temporary.

We agree with the System that H Stock is temporary in nature. In essence, the FCA views the H Stock that is currently outstanding as similar to a 1-day term instrument because of the associations' express willingness to retire it at the request of the holder. Consequently, the FCA believes that, without some enhancement that would improve the stock's stability and permanency, H Stock could not qualify as Tier 2 capital.

Question 12: We seek comments on how to develop a regulatory mechanism to make H Stock more permanent and stable so that the stock may qualify as Tier 2 capital.

C. Regulatory Adjustments

The FCA expects to apply many of the regulatory adjustments currently in our regulations to Tier 1 and total capital. For example, we expect to require System institutions to: 1) Eliminate the double-duty dollars associated with reciprocal holdings with other System institutions, 2) deduct the amount of investments in associations that capitalize loan participations, 3) deduct amounts equal to all goodwill, whenever acquired, 4) deduct investments in the Leasing Corporation, 5) make necessary adjustments for loss-sharing agreements and deferred-tax assets and 6) exclude the net effect of all transactions covered by the definition of other comprehensive income contained in the FASB Codification. We expect to require System associations to deduct their net investments in their affiliated banks from both the numerator and denominator when computing their Tier 1 risk-based capital ratio and non-risk-based leverage ratio. We believe this is consistent with the current Basel I's requirement for unconsolidated financial entities to deduct their investments from regulatory capital to prevent the multiple use of the same capital resource and to gauge the capital adequacy of individual institutions on a stand-alone basis. However, for the purposes of computing the total risk-based capital ratio, a System association could count some or all of its investment in its affiliated bank in accordance with the terms and conditions of bank-association capital allotment agreements. We also may require System institutions to make other deductions from Tier 1 capital or total capital consistent with FFRA guidelines.[67] Finally, we expect to revise § 615.5210(c)(3) prescribing how positions in securitizations that do not qualify for the ratings-based approach affect the numerator of the new regulatory capital ratios.

We are also considering proposing some of the significant new regulatory adjustments that are discussed in the Basel Consultative Proposal. For example, financial institutions may be required to adjust the capital ratios for unrealized losses on debt and equity instruments, loans and receivables, equities, own-use properties and investment properties in our new regulatory capital ratios. The Basel Committee also proposes to deduct pension fund assets as well as fully recognize liabilities that arise from these funds. We expect to consider these regulatory adjustments in our future proposed rulemaking.

Question 13: We seek comments on the regulatory adjustments in our current regulations that we expect to incorporate into the new regulatory capital framework. We also seek comments on the regulatory capital treatment for positions in securitizations that are downgraded and are no longer eligible for the ratings-based approach under a new regulatory capital framework.

IV. Additional Background

A. The October 2007 ANPRM

In our October 2007 ANPRM, we solicited comments on the development of a proposed rule to amend our capital regulations.[68] Most of the questions posed in the October 2007 ANPRM related to the method for calculating the risk-adjusted asset base that serves as the denominator for FCA's risk-based capital ratios. The questions were designed to help us develop a risk-weighting framework consistent with the standardized approach for credit risk[69] as described in the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework"[70] (Basel II).[71] We intend to propose new risk-weighting regulations in a future rulemaking.[72]

Other questions posed in our October 2007 ANPRM related to other aspects of our risk-based regulatory capital framework. For example, we sought comments on a non-risk-based leverage ratio that would apply to all FCS institutions. We also sought comments on an early intervention framework with financial thresholds, such as capital ratios or other risk measures that, when breached, would trigger an FCA capital directive or enforcement action. Of the issues we raised in the October 2007 ANPRM, we reference only the potential addition of a non-risk-based leverage ratio in this ANPRM.

The System Comment Letter submitted in December 2008 recommended, among other things, that we replace our core surplus and total surplus standards with a "Tier 1/Tier 2 structure" consistent with Basel I and FFRA regulations.[73] The letter asserted the System's belief that such revisions would enable the System to operate on a level playing field with commercial banks in accessing the capital markets.[74] The System recommended that the FCA adopt a regulatory capital framework with a 4-percent Tier 1 risk-based capital ratio and an 8-percent total (Tier 1 + Tier 2) risk-based capital ratio. The System also recommended that the FCA replace its net collateral ratio (NCR), which is applicable only to System banks, with a Tier 1 non-risk-based leverage ratio that would be applicable to all System institutions.[75] The System Comment Letter stated that, "because the System's growth has required the use of external equity capital, the System is in regular contact with the financial community, including rating agencies and investors. Obtaining capital at competitive terms, conditions, and rates requires these parties [to] understand the System's and individual institution's financial position, making consistency with approaches used by other regulators, rating agencies, and investment firms a requirement to enhance the capacity of the System to achieve its mission. . . . For the System to achieve its mission, the System must be able to compete with other lenders. Therefore, FCA's capital regulations must result in a regulatory framework that provides for a level playing field, in addition to safe and sound operations."

The FCA believes that adoption of a Tier 1/Tier 2 capital structure (including minimum risk-based and leverage ratios), tailored to the System's structure, could improve the transparency of System capital, could reduce the costs of accessing the capital markets, could reduce the negative effects that can result from differences in regulatory capital standards, and could enhance the safety and soundness of the System.

B. <u>Description of FCA's Current Capital Requirements</u>

In 1985, Congress amended the Act to require the FCA to "cause System institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such System institutions and by using such other methods as the [FCA] deems appropriate."[76] Congress also authorized the FCA to impose capital directives on System institutions.[77] In the Agricultural Credit Act of 1987 (1987 Act), Congress added a definition of "permanent capital" to the Act and required FCA to adopt minimum risk-based permanent capital adequacy standards for System institutions.[78] In 1988, FCA adopted a new regulatory capital framework[79] that established a minimum permanent capital standard for System institutions that, among other things, prohibited the double counting of capital invested by associations in their affiliated banks (i.e., shared System capital).[80]

Section 4.3A of the Act[81] defines permanent capital to include stock (other than stock issued to

System borrowers that is not considered to be at risk),[82] allocated surplus,[83] URE, and other types of debt or equity instruments that the FCA determines are appropriate to be considered permanent capital. The Act explicitly excludes ALL from permanent capital. Our regulations require each System institution to maintain a ratio of at least 7 percent of permanent capital to its risk-adjusted asset base.[84] The method for calculating risk-adjusted assets (which includes both on- and off-balance sheet exposures) is based largely on Basel I and is generally consistent with the FFRAs' Basel I-based risk-weighting categories.[85] From 1988 to 1997, the only regulatory capital requirement imposed on all System banks and associations was the permanent capital standard.

In the mid-1990s, the FCA engaged in a rulemaking to ensure that System institutions held adequate capital in light of the risks undertaken. A feature of the cooperative structure of the System is retail borrowers' expectations of patronage distributions, as well as the expectation that borrower stock will generally be retired when a loan is paid down or paid off. These expectations can influence the permanency and stability of borrower stock and allocated surplus. The FCA was concerned that System associations did not have enough high quality surplus both to maintain and grow operations and at the same time to meet these borrower expectations of stock retirement. The FCA was also concerned that System associations did not have a sufficient level of surplus to buffer borrower stock from unexpected losses and to insulate such institutions from the volatility associated with recurring borrower stock retirements. It was possible for a System association to meet its permanent capital requirements solely with borrower stock. For example, it could establish a stock purchase requirement of 7 percent or more of the borrower's loan amount to meet the minimum permanent capital requirement with little or no surplus to absorb association losses.[86] Furthermore, as noted above, since borrower stock in a cooperative is generally retired in the ordinary course of business upon repayment of a borrower's loan, if the majority of association capital consists of borrower stock, then its capital base is not sufficiently permanent if stock is commonly retired when loans are repaid. The FCA concluded that a minimum surplus requirement was necessary to provide a cushion to protect the borrower's investment in the System association and also to ensure that the institution had a more stable capital base that was not subject to borrowers' expectations of retirement.[87]

The FCA was also concerned that System associations did not have a sufficient amount of what the Agency viewed as "local" surplus—that is, surplus that was completely under the control of the association and immediately available to absorb losses only at the association. Under the 1992 amendments to the Act,[88] a System bank and each of its affiliated associations can determine through a "capital allotment agreement" whether allocated surplus retained at the bank is counted as permanent capital at the bank or at the association for the purposes of computing the permanent capital ratio.[89] Over the years, many System associations had accumulated URE, in part, through non-cash surplus allocations from the bank that were retained by the bank, included in the bank's balance sheet capital, and retired only at the discretion of the bank board. The FCA was concerned that this allocated surplus under the bank's control and at risk at the bank would not always be accessible to the association if either the bank or the association (or both) were to incur losses.[90] The FCA determined that a minimum surplus requirement, which excluded a System association's investment in its affiliated bank, was necessary to: 1) Ensure that each association had a minimum amount of accessible surplus that was not at risk at the bank or at any other System institution, 2) immediately absorb losses and enable the association to continue as a going concern during periods of economic stress, and 3) improve the safety and soundness of the System as a whole.

In 1995, the FCA proposed minimum "surplus" standards to ensure that System institutions had an appropriate mixture of capital components other than borrower stock, such as URE, allocated equities and other types of stock,[91] to achieve a sound capital structure.[92] We initially proposed "unallocated surplus" and "total surplus" standards.[93] The unallocated surplus standard was designed to ensure that System institutions held a sufficient amount of URE that was not available to absorb losses at another System institution. Total surplus was designed to ensure that System institutions held a sufficient amount of capital other than borrower stock so that institutions could fulfill borrower expectations of stock retirements while continuing to hold sufficient capital to operate and grow.[94] Most comments to the 1995 proposed rule centered on the proposed unallocated surplus standard. Respondents were concerned that a high quality minimum surplus requirement that excluded allocated surplus would: 1) Convey the wrong message that allocated surplus was of lower quality than unallocated surplus, 2) create a bias against cooperative principles and 3) result in lower patronage distributions, which could create a competitive disadvantage with non-cooperative agricultural lenders. The FCA considered commenters' views and subsequently published a reproposed rule that replaced the URE standard with a "core surplus" requirement.[95]

As proposed, core surplus included the unallocated surplus (URE and certain perpetual preferred stock but not borrower stock) and NQNSR.[96] Since NQNSR has no financial impact on the borrower (e.g., the borrower does not pay tax on the allocation) and the notice sent to the borrower clearly indicates no plan of redemption, the risk-bearing capacity of NQNSR is very similar to that of URE. Respondents to the 1996 proposed rule supported the addition of NQNSR to core surplus but asserted that the definition was still too restrictive. In addition to the reasons described above, they argued that, while System associations typically establish allocated equity revolvement cycles as a matter of capital planning, the retirements are not automatic and can be reduced or withheld at any time at the board's discretion. The FCA was persuaded that certain allocated equities that are subject to revolvement, while generally not perpetual in nature, do provide important capital protection for as long as they are held. In the final rule, adopted in 1997, the FCA included certain longer-term System association qualified allocated equities in core surplus on the ground that they would help an association build a high quality capital base without discouraging patronage distribution practices.[97]

Respondents also objected to the proposed requirement that an association deduct its net investment in its affiliated bank in its core surplus calculation. We did not change this requirement from what was originally proposed. We emphasized that a measurement of capital not subject to the borrower's expectation of retirement and not available to absorb losses at another System institution was needed to ensure an association could survive independently of its funding bank.

The FCA adopted minimum "core surplus" and "total surplus" standards in 1997.[98] Since that time, the FCA has made only minor changes to the regulatory definitions of core surplus, total surplus and permanent capital.[99] Under existing regulations, core surplus[100] is the highest quality of System capital and includes the following:

(1) URE,
(2) NQNSR,[101]
(3) Perpetual common[102] (excluding borrower stock) or noncumulative perpetual preferred stock,
(4) Other functional equivalents of core surplus,[103] and
(5) For associations, certain allocated equities that are subject to a plan or practice of revolvement or retirement, provided the equities are includible in total surplus and are not intended to be revolved or retired during the next 3 years.[104]

In calculating their core surplus ratio, System associations must deduct their net investment in their affiliated bank.[105] Each System institution must maintain a ratio of at least 3.5 percent of core surplus to its risk-adjusted asset base.[106] Furthermore, allocated equities, including NQNSR, may constitute up to 2 percentage points of the 3.5-percent CSR minimum. This means that at least 1.5 percent of core surplus to risk-adjusted assets must consist of components other than allocated equities.

Total surplus is the next highest form of System institution capital.[107] It includes the following:

(1) Core surplus,
(2) Allocated equities (including allocated surplus and stock), other than those equities subject to a plan or practice of revolvement of 5 years or less,
(3) Common and perpetual preferred stock that is not purchased or held as a condition of obtaining a loan, provided that the institution has no established plan or practice of retiring such stock,
(4) Term preferred stock with an original term of at least 5 years,[108] and
(5) Any other capital instrument, balance sheet entry, or account the FCA determines to be the functional equivalent of total surplus.[109]

Total surplus excludes ALL as well as stock purchased or held by borrowers as a condition of obtaining a loan. Each System institution must maintain a ratio of at least 7 percent of total surplus to its risk-adjusted asset base.[110] The FCA's purpose for adopting the total surplus requirement was to ensure that System institutions, particularly associations, do not rely heavily on borrower stock as a capital cushion. Associations have continued their practice of retiring borrower stock when the borrower's loan is repaid.

Each System bank must maintain a 103-percent minimum NCR requirement that functions as a leverage ratio.[111] The NCR is, generally, available collateral as defined in § 615.5050, less an amount equal to the portion of affiliated associations' investments in the bank that is not counted in the bank's permanent capital, divided by total liabilities. Total liabilities are GAAP liabilities with certain specified adjustments.[112]

C. <u>Overview of the Tier 1/Tier 2 Capital Framework</u>

In 1988, the Basel Committee published Basel I, a two-tiered capital framework for measuring capital adequacy at internationally active banking organizations.[113] Tier 1 capital, or core capital, is composed primarily of equity capital and disclosed reserves (i.e., retained earnings), the highest quality capital elements that are permanent and stable. Tier 2 capital, or supplementary capital, comprises less secure sources of capital and hybrid or debt instruments.[114] Basel I established two minimum risk-based capital ratios: a 4-percent Tier 1 risk-based capital ratio and an 8-percent total (Tier 1 + Tier 2) risk-based capital ratio. For discussion purposes, FCA's core surplus is more similar to Tier 1 capital, whereas total surplus is more similar to total capital. (FCA regulations do not include a ratio similar to Tier 2 capital.)

The Basel Consultative Proposal published in December 2009 proposes many significant changes to the current Tier 1/Tier 2 capital framework.[115] The changes are intended to strengthen global capital regulations with the goal of promoting a more resilient banking sector. The Basel Committee also announced a plan to conduct an impact assessment on the proposed changes in the first half of 2010 and develop a fully calibrated set of standards by the end of 2010. These changes will be phased in as financial conditions improve and the economic recovery is assured, with the aim of full implementation by the end of 2012. We describe the current Tier 1/Tier 2 capital framework and summarize the Basel Committee's proposed changes below.

1. <u>The Current Tier 1/Tier 2 Capital Framework</u>

Tier 1 capital in Basel I consists primarily of equity capital and disclosed reserves. Equity capital is issued and fully paid ordinary shares of common stock and noncumulative perpetual preferred stock. Disclosed reserves are primarily reserves created or increased by appropriations of retained earnings.[116] Disclosed reserves also include general funds that must meet the following criteria: 1) Allocations to the funds must be made out of post-tax retained earnings or out of pre-tax earnings adjusted for all potential liabilities; 2) the funds, including movements into or out of the funds, must be disclosed separately in the bank's published accounts; 3) the funds must be unrestricted and accessible and immediately available to absorb losses; and 4) losses cannot be charged directly to the funds but must be taken through the profit and loss account. In October 1998, the Basel Committee determined that up to 15 percent of Tier 1 capital could include "innovative instruments," provided such instruments met certain criteria.[117]

Tier 2 capital is undisclosed reserves,[118] revaluation reserves, general loan loss reserves, hybrid capital instruments and subordinated debt. Revaluation reserves are reserves that are revalued at their current value (or closer to the current value) rather than at historic cost. The bank must discount any unrealized gains by 55 percent to reflect the potential volatility of this form of unrealized capital, as well as the tax liability charges that would generally be incurred if the unrealized gains were realized. General loan loss reserves are reserves created against the possibility of losses not yet identified. General loan loss reserves can be included in Tier 2 capital up to 1.25 percentage points of risk-weighted assets.[119] Hybrid capital instruments are instruments that have certain characteristics of both equity and debt, such as cumulative preferred stock, and must meet certain criteria to be treated as Tier 2 capital. Subordinated debt and term preferred stock must also meet certain criteria to be treated as Tier 2 capital. This last category is also referred to as "lower Tier 2" capital since subordinated debt and term preferred stock are not normally available to participate in the losses of a bank and are therefore limited to an aggregate amount not to exceed 50 percent of Tier 1 capital (after deductions).

Goodwill and any increases in equity capital resulting from a securitization exposure must be deducted from Tier 1 capital prior to computing the Tier 1 risk-based capital ratio. Investments in unconsolidated financial entities must also be deducted from regulatory capital (as well as from assets): 50 percent from Tier 1 capital and 50 percent from Tier 2 capital. Such deductions prevent multiple uses of the same capital resources by entities that are not consolidated (based on national accounting and/or regulatory systems) and to gauge the capital adequacy of individual institutions on a stand-alone basis. The Basel Committee explained that such deductions are necessary to prevent the double gearing (or double-leveraging) of capital, which can have negative systemic effects for the banking system by making it more vulnerable to the rapid transmission of problems from one institution to another.

In 1989, the FFRAs adopted the Basel I Tier 1 and Tier 2 capital framework with some variations to correspond to the characteristics of the financial institutions they regulate. All FFRAs treat common stockholders' equity (including retained earnings), noncumulative perpetual preferred stock and certain minority interests in equity accounts of subsidiaries[120] as Tier 1 capital.[121] The FRB and FDIC also emphasize in their guidelines that common stockholders' equity should be the predominant form of Tier 1 capital. Tier 2 capital includes a certain portion of qualifying ALL and unrealized holding gains of available-for-sale equity securities, cumulative perpetual and term preferred stock, subordinated debt and other kinds of hybrid capital instruments.[122] Tier 2 capital is limited to 100 percent of Tier 1 capital. Certain Tier 2 capital elements, such as intermediate-term preferred stock and subordinated debt, are limited to 50 percent of Tier 1 capital. The FFRAs' regulations include a 4-percent Tier 1 risk-based capital ratio, an 8-percent total risk-based capital ratio and a 3- or 4-percent minimum leverage ratio requirement.[123] The FFRAs also require certain deductions to be made prior to computing the risk-based capital ratios.

2. Proposed Changes to the Current Tier 1/Tier 2 Framework

In December 2009, the Basel Committee described a number of possible fundamental reforms to the Tier 1/Tier 2 capital framework in its Basel Consultative Proposal. The reforms proposed in the Basel Consultative Proposal would strengthen bank-level, or micro-prudential, regulation, which will help increase the resilience of individual banking institutions during periods of stress. The Basel Committee is also considering a macro-prudential overlay to address procyclicality and systemic risk. The objective of the reforms is to improve the banking sector's ability to absorb shocks arising from financial and economic stress and reduce the risk of spillover from the financial sector to the real economy. The Basel Committee also aims to improve risk management and governance as well as strengthen banks' transparency and disclosures.

The Basel Committee proposes to improve the quality and consistency of Tier 1 capital. The new standards would place greater emphasis on common equity as the predominant form of Tier 1 capital. Common equity means common shares plus retained earnings and other comprehensive income, net of the regulatory adjustments (which can be significant).[124] The Basel Committee has also identified a Tier 1 element it calls "additional going-concern capital," which would be all capital included in Tier 1 that is not common equity.[125] Certain instruments with innovative features that do not meet the criteria of common equity and additional going-concern capital would be phased out of Tier 1 capital over time.

The Basel Consultative Proposal defines Tier 2 capital as capital that provides loss absorption on a gone-concern basis.[126] The criteria that instruments must meet for inclusion in Tier 2 capital would be simplified from the Basel I criteria. All limits and subcategories related to Tier 2 capital would be removed.

The Basel Committee plans to revise the Tier 1 risk-based and total risk-based capital ratios. Since common equity would be the predominant form of Tier 1 capital, the Basel Committee would establish a common equity risk-based minimum to ensure that it equates to a greater portion of Tier 1 capital. The data collected in the impact assessment will be used to calibrate the new minimum required levels and ensure a consistent interpretation of the predominant standard. The regulatory adjustments that are applied to capital, including the new common equity component, would also change.[127]

The Basel Committee is also introducing a non-risk-based leverage ratio as a supplementary "backstop" measure based on gross exposure.[128] A Tier 1 and/or common equity leverage ratio will be considered as possible measures. The leverage ratio would be harmonized internationally, fully adjusting for material differences in accounting, and, unlike the current leverage ratios of the FFRAs, would appropriately integrate off-balance sheet items.

The Basel Committee has included a proposal for capital conservation standards that would reduce the discretion of banks to distribute earnings in certain situations.[129] A Tier 1 capital buffer range would be established above the regulatory minimum capital requirement. When the Tier 1 capital level falls within this range, a bank would be required to conserve a certain percentage of its earnings in the subsequent financial year. Regulators would have the discretion to impose time limits on banks operating within the buffer range on a case-by-case basis. The Basel Committee will use the impact assessment to calibrate the buffer and restrictions of this regulatory capital conservation framework.

Finally, the Basel Committee proposes to improve the transparency of capital. Banks would be required to: 1) Reconcile all regulatory capital elements back to the balance sheet in the audited financial statements; 2) separately disclose all regulatory adjustments; 3) describe all limits and minimums, identifying the positive and negative elements of capital to which the limits and minimums apply; 4) describe the main features of capital instruments issued; and 5) comprehensively explain how the capital ratios are calculated. In addition to the above, banks would be required to make available on their Web sites the full terms and conditions of all instruments included in regulatory capital.[130]

The FFRAs have not yet announced or proposed these recommended changes to their regulatory capital frameworks. However, we note that the FFRAs used higher capital standards consistent with the Basel Consultative Proposal in their "Supervisory Capital Assessment Program" (SCAP) conducted between February and April 2009 to assess the capital adequacy of 19 of the largest U.S. bank holding companies.[131] We also note that the U.S. Treasury's core principles for reforming the U.S. and international regulatory capital framework are consistent with the Basel Committee's recent proposal.[132] Finally, we note that the National Credit Union Administration (NCUA) issued a proposed rule to propose changes to its regulation that would improve the quality of capital at corporate credit unions.[133] Among the regulations the NCUA is proposing is a retained earnings minimum to ensure that a corporate credit union's capital base does not consist of entirely contributed capital. This should provide a cushion to protect against the downstreaming of corporate credit union losses to its natural person credit unions when those institutions could least afford those losses.[134]

The comment period for the Basel Consultative Proposal closed on April 16, 2010. As noted above, the Basel Committee has indicated it plans to issue a "fully calibrated, comprehensive set of proposals' covering all elements discussed in the consultative document. It is expected that Basel Committee member countries will phase in the new standards as their economies improve, with an aim of full implementation by the end of 2012.

Date: June 30, 2010

Roland E. Smith,
Secretary,
Farm Credit Administration Board.

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[1]For the purposes of this ANPRM, "System institutions" include System banks and associations but do not include service organizations or the Federal Agricultural Mortgage Corporation (Farmer Mac).

[2]Banking organizations include commercial banks, savings associations, and their respective holding companies.

[3]72 FR 61568 (October 31, 2007).

[4]Comment letter dated December 19, 2008, from Jamie Stewart, President and CEO, Federal Farm Credit Banks Funding Corporation, on behalf of the System. This letter and its attachments are available in the "Public Comments" section under "Capital Adequacy—Basel Accord—ANPRM" at www.fca.gov.

[5]We refer collectively to the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) as the other "Federal financial regulatory agencies" or FFRAs.

[6]Basel I has been updated several times since 1988. The Basel Committee's documents are available at www.bis.org/bcbs/index/htm.

[7]"Basel Consultative Proposals to Strengthen the Resilience of the Banking Sector," December 17, 2009. The document is available at http://www.bis.org/publ/bcbs164.htm.

[8]12 U.S.C. 2001-2279cc. The Act is available at www.fca.gov under "FCA Handbook."

[9]This is the System's structure as of April 30, 2010. Farmer Mac, which is a corporation and federally chartered instrumentality, is also an institution in the System. The FCA has a separate set of capital regulations that apply to Farmer Mac, and the questions in this ANPRM do not pertain to Farmer Mac's regulations.

[10]See 12 CFR 615.5201-5216 and 615.5301-5336.

[11] See 53 FR 39229 (October 6, 1988) and 63 FR 39229 (July 22, 1998).

[12]This discussion presents a simplified explanation of the System's financial problems in the 1980s. See 60 FR 38521 (July 27, 1995) and 61 FR 42092 (August 13, 1996) for a more comprehensive discussion. These Federal Register documents are available at www.fca.gov. To find them, go to the home page and click on "Law & Regulations," then "FCA Regulations," then "Public Comments," then "View Federal Register Documents."

[13]See Section III.B.1.c. for a more detailed discussion of the bank's required investment.

[14]We are generalizing about how banks retain and distribute capital. In practice, each bank has its own unique policies and practices for retaining and distributing capital. For example, one bank distributes patronage to its associations in the form of either cash or stock, and the associations' investments consist only of bank stock. This bank retires its stock over a long period of time, depending upon its capital needs.

[15]See Section III.B.2.a. for a more detailed discussion of the excess investment.

[16]See Section III.B.1.c. for a more detailed discussion of association borrower stock and allocated surplus.

[17]All associations are required to have capital plans, but these plans may or may not include regular allocated equity revolvement plans.

[18]Third-party capital is capital issued to parties who are not borrowers of the System institution and are not other System institutions. Existing third-party regulatory capital in System institutions includes both preferred stock and subordinated debt.

[19]FRB guidelines for state member banks are in 12 CFR Part 208, App. A, II.A.1. FRB guidelines for bank holding companies (BHCs) are in 12 CFR Part 225, App. A, II.A.1.c(3). FDIC guidelines for state

non-member banks are in 12 CFR Part 325, App. A, I.A.1(b).

[20]URE is earnings not allocated as stock or distributed through patronage refunds or dividends. URE equivalents are other forms of surplus that have the same or very similar characteristics of permanence (i.e., low expectation of redemption), stability and availability to absorb losses as URE.

[21]In other words, if an institution has at least 1.5 percent of uncommitted, unallocated surplus and noncumulative perpetual preferred stock, it may include qualifying allocated equities in core surplus in excess of 2 percentage points.

[22]The NCUA has taken a similar position as it considers adopting a Tier 1/Tier 2 regulatory capital framework for the institutions it regulates. The NCUA has also proposed a retained earnings minimum for corporate credit unions to help prevent the downstreaming of the losses to the credit unions they serve. See 74 FR 65209 (December 9, 2009).

[23]See paragraph 87 of the Basel Consultative Proposal.

[24]See footnote 4 above.

[25]We discuss the individual components of System capital in more detail below in Section III.B.

[26]The FCA currently limits NPPS to 25 percent of core surplus outstanding and imposes aggregate third-party regulatory capital limits of the lesser of 40 percent of permanent capital outstanding or 100 percent of core surplus outstanding. We also limit the inclusion of term preferred stock and subordinated debt to 50 percent of core surplus outstanding. (Institutions can issue third-party stock or subordinated debt in excess of these limits but cannot count it in their regulatory capital.)

[27]Market analysts might perceive a financial institution to be in worse financial condition when it waives preferred stock dividends, because it implies that the institution has previously eliminated its common stock dividends (or, in the case of a cooperative, its patronage).

[28]See also the discussion in Section III.B.1.b.

[29]Section 4.3A(a) of the Act (12 U.S.C. 2154a(a)).

[30]Section 4.3A(d) of the Act (12 U.S.C. 2154a(d)). Any System institution subject to Federal income tax may pay patronage refunds partially in cash as long as the cash portion of the refund is the minimum amount required to qualify the refund as a deductible patronage distribution for Federal income tax purposes and the remaining portion of the refund paid qualifies as permanent capital.

[31]The FCA's regulations are set forth in chapter VI, title 12 of the Code of Federal Regulations and available on the FCA's Web site under "Laws & Regulations."

[32]See paragraph 89 of the Basel Consultative Proposal.

[33]The associations refer to NQNSR in various ways such as "nonqualified retained earnings" or "nonqualified retained surplus." The System Comment Letter refers to bank NQNSR as "nonqualified allocated stock to cooperatives not subject to revolvement."

[34]On June 30, 2009, the Financial Accounting Standards Board (FASB) established the FASB Accounting Standards Codification™ (FASB Codification or ASC) as the single source of authoritative nongovernmental U.S. GAAP. In doing so, the FASB Codification reorganized existing U.S. accounting and reporting standards issued by the FASB and other related private-sector standard setters. More information about the FASB Codification is available at http://asc.fasb.org/home.

[35]This guidance was formerly included in pre-codification reference Statement of Financial Accounting Standards (SFAS) No. 141(R), Business Combinations, and is now incorporated into the FASB Codification at ASC Topic 805, Business Combinations.

[36]Since the System submitted its comment letter in December 2008, there have been several System mergers that were accounted for under the acquisition method and resulted in recording additional paid-in capital similar to the System's examples.

[37]See 12 CFR Part 225, App. A, II.A.1.c.ii(2) for BHCs and Part 208, App. A, II.A.1.b for state member banks. If the dividend rate is reset periodically based, in whole or in part, on the institution's current credit standing, it is not treated as Tier 1 capital. However, adjustable rate NPPS where the dividend rate is not affected by the issuer's credit standing or financial condition but is adjusted periodically according to a formula based solely on general market interest rates may be included in Tier 1 capital.

[38]See 12 CFR Part 325, App. B, IV.B. This is an issuance with a low initial rate that is scheduled to escalate to much higher rates in subsequent periods and become so onerous that the bank is effectively forced to call the issue.

[39]The OTS may allow this type of NPPS to qualify as Tier 1. See 73 FR 50326 (August 26, 2008), "Joint Report: Differences in Accounting and Capital Standards Among the Federal Banking Agencies; Report to the Congressional Basel Committees."

[40]See paragraphs 88 and 89 of the Basel Consultative Proposal.

[41]The minimum may not be lower than the statutory minimum stock purchase requirement of $1,000 or 2 percent of the loan amount, whichever is less (section 4.3A (c)(1)(E) of the Act). The banks also have other programs in which associations and other lenders participate that require investment in the bank. We collectively refer to these investments as the bank's required minimum investment.

[42]The bank board may increase or decrease this minimum within the required investment range from time to time, depending upon the capital needs of the bank.

[43]For more detail on CoBank's target equity level, see CoBank's 2008 Annual Report. This document is available at www.cobank.com.

[44]Section 4.3A(c)(1)(E) of the Act (12 U.S.C. 2154a(c)(1)(E)).

[45]CoBank stated in its 2008 annual report that the target equity level is expected to be 8 percent of the 10-year historical average loan volume for 2009 and remain at that level thereafter.

[46]Under section 4.3A(c)(1)(I) of the Act (12 U.S.C. 2154a(c)(1)(I)), this stock is retired at the discretion of

the association.

[47]62 FR 4429 (January 30, 1997).

[48]The System indicates in its comment that it views FHLB "permanent capital" as the equivalent of Tier 1 capital.

[49]The System also noted that the FASB has recognized cooperative capital as equity even if a portion of it is redeemable. While this is true, it does not support the argument that allocated surplus and member stock should be treated as Tier 1 capital rather than Tier 2 capital.

[50]See 12 U.S.C. 1426.

[51]U.S. commercial banks and savings associations must, in many cases, notify or seek the prior approval of their primary FFRA before making a capital distribution (stock retirements or dividends in the form of cash). The notification requirements and/or restrictions enhance the permanence and stability of Tier 1 capital elements for such entities. For national banks, see 12 U.S.C. 59, 60; 12 CFR 5.46, 5.60-5.67. For state banks, see 12 CFR 208.5; 12 U.S.C. 1828(i), 12 CFR 303.203, 303.241. For savings associations, see 12 U.S.C. 1467a(f); 12 CFR 563.140-563.146.

[52]Congress established the Prompt Corrective Action framework in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 with the objective to prevent a reoccurrence of the large-scale failures of bank and thrift institutions that depleted the Federal deposit insurance funds in the 1980s. For information about the use and effectiveness of the Prompt Corrective Action framework see GAO, Bank and Thrift Regulation: Implementation of FDICIA's Prompt Regulatory Action Provisions, GAO/GGD-97-18 (Washington, D.C.: Nov. 21, 1996), and GAO, Deposit Insurance: Assessment of Regulators Use of Prompt Corrective Action Provisions and FDIC's New Deposit Insurance System, GAO-07-242 (Washington D.C.: February 2007).

[53]"Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms" (September 3, 2009). This document is available at http://www.ustreas.gov/.

[54]Other comprehensive income (OCI) is the difference between net income and comprehensive income and represents certain gains and losses of an enterprise. OCI generally refers to revenues, expenses, gains, and losses that under U.S. GAAP are included in comprehensive income but excluded from net income. For System institutions, the most common items in OCI have recently been pension liability adjustments, unrealized gains or losses on available-for-sale securities, and other-than-temporary impairment on investments available-for-sale. The accumulated balances of those items are required by those respective standards to be reported in a separate component of equity in a company's balance sheet. The principal source of guidance on comprehensive income and OCI under U.S. GAAP is at ASC Topic 220, Comprehensive Income.

[55]We note that the Basel Consultative Proposal has a similar concept to limit capital distributions, including limits on dividend payments and share buybacks, to ensure that banking organizations hold higher amounts of high quality capital during good economic situations so as to be drawn down during periods of stress. See paragraphs 39 and 40 of the Basel Consultative Proposal.

[56]The Basel Committee will determine the amount of allowance for loan losses to be included in Tier 2 capital after conducting its mid-year 2010 impact assessment.

[57]See 12 CFR 615.5207-5208.

[58]See section 4.4(a)(2)(A) of the Act (12 U.S.C. 2155(a)(2)(A)).

[59](12 U.S.C. 2154a(a)(1)(C).

[60]The Basel Committee may remove or modify this percentage after conducting its mid-year 2010 impact assessment.

[61]The more advanced approaches of Basel II have a different formula for determining the amount of general loan loss reserves that can be included in Tier 2 capital. Basel II is discussed briefly in Section IV of this document.

[62]For descriptions of cumulative perpetual preferred stock and long-term stock, see the OCC's guidelines at 12 CFR Part 3, App. A, 1(c)(26) and 2(b)(2). See the FRB's guidelines at 12 CFR Part 225, App. A, II.A.2.b and 12 CFR Part 208, App. A, II.A.2.b. See the FDIC's guidelines at 12 CFR Part 325, App. A, I.A.2.ii and I.A.2.b. See the OTS's guidelines (for cumulative perpetual preferred stock) at 12 CFR 567.5(b)(1).

[63]FCA defines "term preferred stock" in § 615.5201 as stock with an original maturity date of at least 5 years and on which, if cumulative, the board of directors has the option to defer dividends, provided that, at the beginning of each of the last 5 years of the term of the stock, the amount that is eligible to be counted as permanent capital is reduced by 20 percent of the original amount of the stock (net of redemptions).

[64]Pre-codification reference: SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, was issued in May 1993 and effective for fiscal years beginning after December 15, 1993. This statement is now incorporated into ASC Topic 320, Investments—Debt and Equity Securities. See 63 FR 46518 (September 1, 1998).

[65]See the OCC's guidelines at 12 CFR Part 3, App. A, 2.b.5. See the FRB's guidelines at 12 CFR Part 225, App. A, II.A.2(v) and II.A.e; and 12 CFR Part 208, App. A, II.A.2(v) and II.A.e. See the FDIC's guidelines at 12 CFR Part 325, App. A, I.A.2(iv) and I.A.2.f. See the OTS's guidelines at 12 CFR 567.5(b)(5).

[66]See the OCC's guidelines at 12 CFR Part 3, App. A, 2.b.5. See the FRB's guidelines at 12 CFR Part 225, App. A, II.A.2(iv) and II.A.2.d; and 12 CFR Part 208, App. A, II.A.2(iv) and II.A.2.d. See the FDIC's guidelines at 12 CFR Part 325, App. A, I.A.2(v) and I.A.2.d. See the OTS's guidelines at 12 CFR 567.5(b)(1)(vi) and (b)(2)(ii).

[67]See the OCC's guidelines at 12 CFR Part 3, App. A, 2.c. See the FRB's guidelines at 12 CFR Part 225, App. A, II.B. and 12 CFR Part 208, App. A, II.B. See the FDIC's guidelines at 12 CFR Part 325, App. A, I.B. See the OTS's guidelines at 12 CFR 567.5(a)(2).

[68]See 72 FR 61568 (October 31, 2007). The original comment period of 150 days was later extended to December 31, 2008. We note that, in the October 2007 ANPRM, FCA withdrew a previous ANPRM published in June 2007 (72 FR 34191, June 21, 2007) in which we had sought comments to questions based on a proposed regulatory capital rulemaking (referred to as Basel IA) published by the FFRAs in

December 2006. The FFRAs later withdrew the Basel IA proposal. For that reason, we withdrew the June 2007 ANPRM and published the October 2007 ANPRM. The FFRAs replaced the Basel 1A rulemaking with the July 2008 proposal based on the Basel II standardized approach.

[69]We also asked for comments on what approach we should consider in determining a risk-based capital charge for operational risk.

[70]See www.bis.org/publ/bcbsca.htm for the 2004 Basel II Accord as well as updates in 2005 and 2006.

[71]The Basel Committee on Banking Supervision was established in 1974 by central banks with bank supervisory authorities in major industrialized countries. The Basel Committee formulates standards and guidelines related to banking and recommends them for adoption by member countries and others. All Basel Committee documents are available at http://www.bis.org.

[72]The FFRAs are in the process of implementing multiple sets of capital rules for the financial institutions they regulate. In December 2007, the FFRAs adopted a regulatory capital framework consistent with the advanced approaches of Basel II that is applicable to only a few internationally active banking organizations. See 72 FR 69288 (December 7, 2007). In July 2008, the FFRAs proposed a regulatory capital framework consistent with the standardized approach for credit risk and basic indicator approach for operational risk under Basel II to help minimize the potential differences in the regulatory minimum capital requirements of those banks applying the advanced approaches and those banks applying the more simplified approaches. See 73 FR 43982 (July 29, 2008). The FFRAs have not yet acted on this proposal.

[73]See footnote 4 above.

[74]The FCA also received six comment letters from individual System institutions pertaining to the treatment of certain capital components as Tier 1 capital. We address these comments below.

[75]The System also recommended many changes to our risk-weighting regulations, which we will address in a future rulemaking.

[76]Section 4.3(a) of the Act (12 U.S.C. 2154(a)).

[77]Section 4.3(b) of the Act (12 U.S.C. 2154(b)). This provision is nearly identical to legislation enacted in 1983 with respect to the other FFRAs. See 12 U.S.C. 3097.

[78]Section 4.3A of the Act; section 301(a) of Pub. L. 100-233, as amended by the Agricultural Credit Technical Corrections Act of 1988, Pub. L. 100-399, title III, section 301(a), August 17, 1988, 102 Stat. 93.

[79]See 53 FR 39229 (October 6, 1988). The FCA's objective at this time was to develop a permanent capital standard consistent with the statute. We determined not to adopt the two-tiered capital structure of Basel I because of significant differences between statutory permanent capital and Tier 2 capital.

[80]The 1988 regulation required an association to deduct the full amount of its investment in its affiliated bank before computing its PCR. This requirement had a phase-in period that was to begin in 1993. In 1992, Congress amended the statutory definition of permanent capital to permit System banks and associations to specify by mutual agreement the amount of allocated equities that would be considered

bank or association equity for the purpose of calculating the PCR. In July 1994, the FCA amended the regulations to implement this statutory change. See 59 FR 37400 (July 22, 1994).

[81]Section 4.3A(a)(1) of the Act (12 U.S.C. 2154a(a)(1)).

[82]Borrower stock is common shareholder equity that is purchased as a condition of obtaining a loan with a System institution. We include in this category participation certificates, which are a form of equity issued to persons or entities that are ineligible to own borrower voting stock, such as rural home borrowers. To be counted as permanent capital, stock must be at risk and retireable only at the discretion of an institution's board of directors. Any stock that may be retired by the holder of the stock on repayment of the holder's loan, or otherwise at the option or request of the holder, or stock that is protected under section 4.9A of the Act or is otherwise not at risk, is excluded from permanent capital. Stock protected by section 4.9A of the Act was issued prior to October 1988, and nearly all such stock has been retired.

[83]Allocated surplus is earnings allocated but not paid in cash to a System institution borrower. Allocated surplus is counted as permanent capital provided the bylaws of a System institution clearly specify that there is no express or implied right for such capital to be retired at the end of the revolvement cycle or at any other time. In addition, the institution must clearly state in the notice of allocation that such capital may be retired only at the sole discretion of the board of directors in accordance with statutory and regulatory requirements and that no express or implied right to have such capital retired at the end of the revolvement cycle or at any other time is thereby granted.

[84]See § 615.5205. Before making this computation, each System institution is required to make certain adjustments and/or deductions to permanent capital and/or the risk-adjusted asset base.

[85]See §§ 615.5211-615.5212. Under the current framework, each on- and off-balance sheet credit exposure is assigned to one of five broad risk-weighting categories (0, 20, 50, 100, and 200 percent) or dollar-for-dollar deduction) to determine the risk-adjusted asset base, which is the denominator for all of FCA's risk-based capital ratios.

[86]Before the 1987 Act took effect, the FLBAs had authority to set a borrower stock requirement of not less than 5 percent nor more than 10 percent of the amount of the loan, and the associations were required to retire the stock upon full repayment of the loan. The PCAs had a statutory minimum borrower stock requirement of 5 percent, and such stock could be canceled or retired on repayment of the loan as provided by the association's bylaws; in addition, an association could also require borrowers to purchase stock or provide an equity reserve in an amount up to another 5 percent of the loan. The 1987 Act changed these provisions by eliminating the mandatory stock retirements when long-term real estate loans were repaid and by allowing System institutions to choose their stock purchase requirement as long as it was not below the lesser of $1,000 or 2 percent of the loan.

[87]At the time, the System generally supported the FCA's position and recommended that we establish regulatory standards requiring all System institutions to build unallocated surplus and total surplus (e.g., both allocated and unallocated surplus). To meet these new standards, the FCS suggested that each System institution retain a portion of its net earnings after taxes to achieve and maintain at least 3.5 percent in unallocated surplus and 7.0 percent in total surplus of the institution's risk-adjusted assets. The FCA chose instead to establish fixed minimums but permitted institutions with capital below the minimums to achieve compliance initially by submitting capital restoration plans.

[88]Farm Credit Banks and Associations Safety and Soundness Act of 1992, Pub. L. 102-552, 106 Stat. 4102 (October 28, 1992).

[89]See §§ 615.5207(b)(2) and 615.5208 for the provisions regarding the capital allotment agreements.

[90]It is important to distinguish the terms "allocated surplus" and "allotted surplus." From a bank perspective, allocated surplus is earnings allocated to an association and retained at the bank. It is counted in either the bank's regulatory capital or the association's regulatory capital. "Allotted surplus" is the term we use to describe how the allocated surplus is counted according to an allotment agreement when calculating regulatory capital ratios. We describe the System banks' retention and distribution of capital in Section III.A.1. and Section III.B.1.c.

[91]This is stock that is not required to be purchased as a condition of obtaining a loan and that is not routinely retired.

[92]We also proposed a minimum NCR requirement (a type of leverage ratio) for System banks above the statutory minimum collateral requirement to protect investors and allow sufficient time for corrective action to be implemented prior to a funding crisis at an individual bank (see below). See 60 FR 38521 (July 27, 1995).

[93]The proposed definition of unallocated surplus included URE and common and noncumulative perpetual preferred stock held by non-borrowers but excluded allocated surplus, borrower stock and ALL. System associations also had to deduct their net investments in their affiliated bank before computing the unallocated surplus ratio. The proposed definition of total surplus included both unallocated and allocated surplus, including allotted surplus, as well as various types of common and preferred stock, but excluded borrower stock and ALL.

[94]In the final rule, adopted in 1997, the total surplus requirement remained mostly unchanged from what was originally proposed. See 62 FR 4429 (January 30, 1997).

[95]See 61 FR 42092 (August 13, 1996).

[96]NQNSR (nonqualified allocated equities not subject to revolvement) is equity retained by a cooperative institution from after-tax earnings. The System institution pays the tax on earnings and issues a notice of allocation to its members specifying the amount that has been earmarked for potential distribution. The "non-revolvement" feature indicates that no redemption is anticipated in the near future.

[97]See 62 FR 4429 (January 30, 1997). We determined at the time not to include System bank allocated equities in core surplus. This primarily affected CoBank, which operates a significant retail operation (the other System banks are primarily wholesale operations). However, since March 2008, we have temporarily permitted CoBank to include a portion of its allocated equities in core surplus consistent with our treatment of association allocated equities until this issue could be addressed through a rulemaking.

[98]See 62 FR 4429 (January 30, 1997).

[99]In 1998 we made minor wording changes to the total surplus and core surplus definitions to clarify certain terms and phrases. See 63 FR 39219 (July 22, 1998). In 2003, we changed the definition of permanent capital to reflect a 1992 statutory change to section 4.3A of the Act and added a restriction to the amount of term preferred stock includible in total surplus. See 68 FR 18532 (April 16, 2003).

[100]Core surplus is defined in § 615.5301(b).

[101]In the event that NQNSR are distributed, other than as required by section 4.14B of the Act (statutory restructuring of a loan), or in connection with a loan default or the death of an equityholder whose loan has been repaid (to the extent provided for in the institution's capital adequacy plan), any remaining NQNSR that were allocated in the same year will be excluded from core surplus.

[102]Certain classes of common stock issued by System institutions are typically never retired except in the event of liquidation or merger. However, there is only a small amount of these classes of stock currently outstanding. In the event that such stock is retired, other than as required by section 4.14B of the Act, or in connection with a loan default to the extent provided for in the institution's capital adequacy plan, any remaining common stock of the same class or series has to be excluded from core surplus.

[103]The FCA may permit an institution to include all or a portion of any instrument, entry, or account it deems to be the functional equivalent of core surplus, permanently or on a temporary basis.

[104]We explained in the 1997 final rule our belief that 3 years should be sufficient time for a System association experiencing adversity to adjust its allocation plans and take other protective measures while continuing to be able to make planned patronage distributions. The rule further provides that, in the event that such allocated equities included in core surplus are retired, other than in connection with a loan default or restructuring or the death of an equityholder whose loan has been repaid (to the extent provided for in the institution's capital adequacy plan), any remaining such allocated equities that were allocated in the same year must be excluded from core surplus.

[105]System banks cannot include their affiliated associations' investments in core surplus. The net investment is the total investment by an association in its affiliated bank, less reciprocal investments and investments resulting from a loan originating/service agency relationship, such as participation loans. See § 615.5301(e).

[106]Each System institution is also required to make certain other deductions and/or adjustments before computing its core surplus ratio. See 12 CFR 615.5301(e).

[107]Total surplus is defined in § 615.5301(i).

[108]Term preferred stock is limited to a maximum of 25 percent of the institution's permanent capital (as calculated after deductions required in the PCR computation). The amount of includible term stock must be reduced by 20 percent (net of redemptions) at the beginning of each of the last 5 years of the term of the instrument.

[109]The FCA may permit one or more institutions to include all or a portion of such instrument, entry, or account as total surplus, permanently or on a temporary basis.

[110]As with the other capital ratios, each System institution is also required to make certain other deductions and/or adjustments before computing its total surplus ratio.

[111]See § 615.5301(c) and (d) and § 615.5335.

[112]See § 615.5301(j).

[113]In 1996, the Basel Committee added a third capital tier to support market risk, commodities risk and foreign currency risk in relation to trading book activities. However, in the Basel Consultative Proposal, the Basel Committee has proposed to abolish Tier 3 to ensure that market risks are supported by the same quality of capital as credit and operational risk.

[114]Total capital is the sum of Tier 1 and Tier 2 capital. Currently, Tier 2 capital may not account for more than 50 percent of a commercial bank's total capital.

[115]See footnote 7 above.

[116]The Basel Committee has emphasized over the years that the predominant form of Tier 1 capital should be voting common stockholder's equity and disclosed reserves. Common shareholders' funds allow a bank to absorb losses on an ongoing basis and are permanently available for this purpose. It best allows banks to conserve resources when they are under stress because it provides a bank with full discretion as to the amount and timing of distributions. It is also the basis on which most market judgments of capital adequacy are made. The voting rights attached to common stock provide an important source of market discipline over a commercial bank's management.

[117]The Basel Committee determined that all Tier 1 capital elements, including these instruments, must have the following characteristics: 1) Issued and fully paid, 2) noncumulative, 3) able to absorb losses within a bank on a going-concern basis, 4) junior to depositors, general creditors, and subordinated debt of the bank, 5) permanent, 6) neither be secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors and 7) callable at the initiative of the issuer only after a minimum of 5 years with supervisory approval and under the condition that it will be replaced with capital of the same or better quality unless the supervisor determines that the bank has capital that is more than adequate to its risks. See "Instruments eligible for inclusion in Tier 1 capital" (October 27, 1998). This document is available at www.bis.org.

[118]Although Basel I includes them in Tier 2 capital, the FCA would likely not recognize undisclosed reserves as Tier 2 capital under a new regulatory capital framework.

[119]This is applicable to capital rules that are based on either Basel I or the Basel II standardized approach. The advanced approaches of Basel II have a different formula for determining the amount of general loan loss reserves in Tier 2 capital.

[120]Minority interests in equity accounts of subsidiaries represent stockholders' equity associated with common or noncumulative perpetual preferred equity instruments issued by an institution's consolidated subsidiary that are held by investors other than the institution. They typically are not available to absorb losses in the consolidated institution as a whole, but they are included in Tier 1 capital because they represent equity that is freely available to absorb losses in the issuing subsidiary. Some of the FFRAs restrict these minority interests to 25 percent of Tier 1 capital.

[121]The OTS and FRB have additional elements in Tier 1 capital. For example, the OTS permits some of its institutions to include nonwithdrawable accounts and pledged deposits in Tier 1 capital to the extent that such accounts have no fixed maturity date, cannot be withdrawn at the option of the accountholder and do not earn interest that carries over to subsequent periods. The FRB permits certain BHCs to treat certain "restricted core capital elements" (restricted elements) as Tier 1 capital. Restricted elements include

qualifying cumulative perpetual preferred stock and cumulative trust preferred securities, which are limited to 25 percent of Tier 1 capital. The FRB has recently decreased this limit to 15 percent of Tier 1 capital for certain internationally active BHCs but has delayed the effective date to March 31, 2011. See 70 FR 11827 (March 10, 2005) and 74 FR 12076 (March 23, 2009).

[122]The FFRA's elements of Tier 2 capital are discussed in more detail below.

[123]The minimum leverage ratio requirement depends on the type of institution and a regulatory assessment of the strength of its management and controls. Banks holding the highest supervisory rating and not growing significantly have a minimum leverage ratio of 3 percent; all other banks must meet a leverage ratio of at least 4 percent.

[124]Common shares must meet a set of criteria to be included in Tier 1 capital. See paragraph 87 of the Basel Consultative Proposal.

[125]Additional going concern capital must meet a set of criteria to be included in Tier 1 capital. See paragraphs 88 and 89 of the Basel Consultative Proposal.

[126]Instruments must meet or exceed a set of criteria to be included in Tier 2 capital. See paragraph 90 of the Basel Consultative Proposal.

[127]A description of the regulatory adjustments can be found in paragraphs 93 through 108 of the Basel Consultative Proposal.

[128]See paragraphs 202 through 207 of the Basel Consultative Proposal.

[129]See paragraphs 247 through 259 of the Basel Consultative Proposal.

[130]See paragraphs 80 and 81 of the Basel Consultative Proposal.

[131]A detailed white paper on the SCAP data and methodology was published in April 2009, and the results were published in May 2009. See "The Supervisory Capital Assessment Program: Design and Implementation" (April 24, 2009) and "The Supervisory Capital Assessment Program: Overview of Results" (May 7, 2009). These documents are available at www.federalreserve.gov.

[132]See "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms," (September 3, 2009). This document is available at http://www.ustreas.gov.

[133]See 74 FR 65209 (December 9, 2009).

[134]See also Statement of Michael E. Fryzel, Chairman of NCUA, on "H.R. 2351: The Credit Union Share Insurance Stabilization Act" before the U.S. House of Representatives, Basel Committee on Financial Services, SubBasel Committee on Financial Institutions and Consumer Credit (May 20, 2009). This document is available at: www.ncua.gov.

76 FR 53344, 08/26/2011

Handbook Mailing HM-11-10

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AC71

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

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking.

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

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

ADDRESSES: There are several methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (faxes) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.

- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."

- Federal E-Rulemaking Web site: http://www.regulations.gov. Follow the instructions for submitting comments.

- Mail: Send mail to Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

  You may review copies of comments we receive at our office in McLean, Virginia, or on our

Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

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or

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I. Background

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

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

II. FCA's Risk-Based Capital Standards

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

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

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

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

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

III. Request for Comment

A. Creditworthiness Standards

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

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

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

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

Question 2: How can we assure ratings consistency over time, across System institutions, and maintain consistency with the ratings of similar assets by commercial banks and other capital market participants? Should the creditworthiness standards developed for regulatory capital purposes be the same as those developed for regulation of the investment management or liquidity activities of FCS institutions?

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

In response to the mandate of section 939A of Dodd-Frank, OFFRs have issued ANPRMs or proposed rulemakings seeking comment on credit-rating alternatives. The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision issued a joint ANPRM in August 2010.[9] The National Credit Union Administration (NCUA) issued a Notice of Proposed Rulemaking in March 2011.[10] The Federal Housing Finance Agency (FHFA) issued an ANPRM in January 2011.[11]

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

C. Assignment of Risk Weights

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

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

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

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

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

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

One way to eliminate reliance on NRSRO ratings would be to require FCS institutions to develop internal risk exposure methodologies for making creditworthiness determinations for certain exposures. In some cases, FCS institutions may need to contract with third parties to obtain quantitative data, such as probabilities of default, as part of their internal process for making such determinations. Also, FCS institutions could continue to use the opinions of external experts as an element in assessing creditworthiness. Regardless of the approach we adopt, we would establish criteria to ensure that the methodology employed is consistent with safe and sound banking practices.

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

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

E. Burden

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

Date: August 18, 2011

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

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

[2] See section 939A, Pub. L. 111-203, 124 Stat. 1376 (July 21, 2010).

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

[4] See 62 FR 4429 (Jan. 30, 1997).

[5] See 63 FR 39219 (Jul. 22, 1998).

[6] See 70 FR 35336 (Jun. 17, 2005).

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

[8]See 72 FR 34191 (Jun. 21, 2007), 72 FR 61568 (Oct. 31, 2007), 75 FR 39392 (Jul. 8, 2010).

[9]See 75 FR 52283 (Aug. 25, 2010).

[10]See 76 FR 11164 (Mar. 1, 2011).

[11]See 76 FR 5292 (Jan. 31, 2011).

[12]See 75 FR 52283 (Aug. 25, 2010).

76 FR 80817, 12/27/2011

Handbook Mailing HM-11-14

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AC54

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Liquidity and Funding

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, we or us) proposes to amend its liquidity regulation. The purpose of the proposed rule is to strengthen liquidity risk management at Farm Credit System (FCS or System) banks, improve the quality of assets in the liquidity reserve, and bolster the ability of System banks to fund their obligations and continue their operations during times of economic, financial, or market adversity.

DATES: Comments should be received on or before February 27, 2012.

ADDRESSES: We offer a variety of methods for you to submit your comments. For accuracy and efficiency, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Comments" and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of comments we receive at our office in McLean, Virginia, or from our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

David J. Lewandrowski, Senior Policy Analyst, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA, (703) 883-4498, TTY (703) 883-4434;

or

Richard A. Katz, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of the proposed rule are to:

- Improve the capacity of FCS banks to pay their obligations and fund their operations by maintaining adequate liquidity to withstand various market disruptions and adverse financial or economic conditions;
- Strengthen liquidity management at all FCS banks;
- Enhance the marketability of assets that System banks hold in their liquidity reserve;
- Require that cash and highly liquid investments comprise the first 30 days of the 90-day liquidity reserve;
- Establish a supplemental liquidity buffer that a bank can draw upon during an emergency and that is sufficient to cover the bank's liquidity needs beyond the 90-day liquidity reserve; and
- Strengthen each bank's Contingency Funding Plan (CFP).

II. Background

The FCS is a nationwide network of borrower-owned financial cooperatives that lend to farmers, ranchers, aquatic producers and harvesters, agricultural cooperatives, rural utilities, farm-related service businesses, and rural homeowners. By law, FCS institutions are instrumentalities of the United States,[1] and Government-sponsored enterprises (GSEs).[2] According to section 1.1(a) of the Farm Credit Act of 1971, as amended, (Act), Congress established the System for the purpose of furnishing "sound, adequate, and constructive credit and closely related services" to farmers, ranchers, aquatic producers and harvesters, their cooperatives, and certain farm-related businesses necessary to fund efficient agricultural operations in the United States.

In many respects, the FCS is different from other lenders. In contrast to commercial banks and most other financial institutions, the System lends mostly to agriculture and in rural areas. Unlike most other lenders, FCS banks and associations are cooperatives that are owned and controlled by their agricultural borrowers, and their common equity is not publicly traded.

The System funds its operations differently than most commercial lenders. FCS banks issue System-wide debt securities, which are the System's primary source for funding loans to agricultural producers, their cooperatives, and other eligible borrowers.[3] Although section 4.2(a) of the Act authorizes FCS banks to borrow from commercial banks and other lending institutions, lines of credit with non-System lenders are a negligible source of FCS funding. FCS banks and associations are not depository institutions.

The System's ability to finance agriculture, rural housing, and rural utilities in both good and bad economic times primarily depends on continuing access to the debt markets. During normal economic conditions, access to debt markets provides the System with funds it needs to operate. However, if access to the debt markets becomes impeded for any reason, Farm Credit banks must rely on assets to continue operations and pay maturing obligations. Liquidity is the ability to convert assets into cash quickly and at a price that is close to their book value.

In contrast to commercial banks, savings associations, and credit unions, the FCS does not have guaranteed access to a government provider of liquidity in an emergency.[4] If market access is impeded, FCS banks must rely on their liquidity reserves more heavily than other federally regulated lending institutions[5] because they do not have a assured lender of last resort.[6]

The liquidity of System banks has drawn more scrutiny from the FCA, credit rating agencies, and investors as economic and financial turmoil have roiled the markets with greater frequency and magnitude in recent years. As a result, the FCA proposes to amend its liquidity regulations so that FCS banks are better able to withstand uncertainty and instability in the financial markets.[7]

Liquidity is important for the financial system as a whole. Recent market disruptions have raised concerns among regulators, credit rating agencies, investors, and other market participants about the ability of financial institutions to maintain sufficient liquidity to meet their immediate funding needs during times of economic and financial turmoil.[8] The experience of these crises demonstrates why sound liquidity risk management is important to the safety and soundness of individual financial institutions and the financial system as a whole.

Regulatory agencies, in particular, have responded by formulating more comprehensive supervisory approaches toward liquidity risk management at financial institutions. For example, the Basel Committee on Banking Supervision (Basel Committee) issued in September 2008, the Principles for Sound Liquidity Risk Management and Supervision, which contains 17 principles detailing international supervisory guidance for sound liquidity risk management. In December, 2010, the Basel Committee issued Basel III: International framework for liquidity risk measurement, standards, and monitoring (Basel III Liquidity Framework). On March 22, 2010, the five Federal agencies that regulate depository institutions (Federal banking agencies)[9] published their Interagency Policy Statement on Funding and Liquidity Risk Management[10], which sets forth the supervisory expectations for depository institutions. The purpose of all these documents is to guide the supervisory efforts of Federal and international regulators of depository institutions into the future.

The FCA has considered the guidance of both the Basel Committee and the Federal banking agencies as part of its efforts to develop revised liquidity regulations. Many of the core concepts that the Basel Committee and the Federal banking agencies articulated about liquidity are appropriate for our proposed rule. However, the corporate, funding, and lending structures of the FCS are fundamentally different from those of depository institutions and, therefore, the FCA has modified and adapted the guidance of international regulators and Federal banking agencies concerning liquidity risk management so they are relevant to the System's unique circumstances, needs, and structure. The FCA also added other requirements that are tailored to the System's unique nature.

In addition to the guidance of the Basel Committee and other Federal regulators, both the FCA and the System have implemented various measures to improve liquidity management so FCS banks are in a better position to withstand financial and economic shocks. More specifically, System banks agreed to a common framework that stipulated the days of liquidity coverage that they would maintain, and established the parameter for the quality of investments held in their liquidity reserves.

The FCA also took action to improve the ability of FCS banks to maintain sufficient liquidity to outlast episodes of market turbulence. On November 13, 2008, the FCA Board passed a Market Emergency Standby Resolution that waives the 90-day liquidity reserve requirement in § 615.5134 for a limited period of time if a crisis shuts, or severely restricts access to, debt markets. On May 5, 2009, the FCA issued a letter to FCS banks and the Funding Corporation that required the standing monthly collateral certification of all banks to include detailed information about days of liquidity in a specified format. This directive also required reporting of days of liquidity for each FCS bank and the FCS in aggregate, and detailed information about the type and remaining term of the investments from which those days of liquidity are derived.

FCS banks withstood recent economic and financial turmoil with their liquidity intact. Both the FCA and FCS have gained valuable experience and insights into the effects that sudden and severe stress have on liquidity at individual FCS institutions and the financial system as a whole. The FCA has identified several vulnerabilities that need to be addressed:

(1) Banks must ensure that the liquidity reserve is managed primarily as an emergency source of funding;

(2) Board policies need to provide clearer guidance to the asset-liability committee (ALCO) for monitoring, measuring, and managing liquidity risk;

(3) Risk analyses need to address how investments that the bank purchases and hold actually achieve its primary liquidity objective.

(4) Contingency funding plans need to provide orderly and effective procedures that would allow the bank to maintain sufficient liquidity to fund its operations during each phase of an emerging crisis;

(5) Discounts that FCS banks apply to the market values of assets in the liquidity reserve pursuant to current § 615.5134(c) need to be increased for certain types of investments;

(6) Counterparty risk needs to be reduced; and

(7) Liquidity policies need to take into account the continuing uncertainty as to whether the Federal Reserve System would provide a line of credit to FCS banks under section 13(3) of the Federal Reserve Act during a systemic liquidity crisis.

As our colleagues at international financial regulators and the Federal banking agencies are doing, we are drawing conclusions from the lessons that we learned during recent crises. As a result, we are revising our regulatory and supervisory approaches towards liquidity so that System institutions are in a better position to withstand whatever future crises may arise. As part of our ongoing efforts to limit the adverse effect of rapidly changing economic, financial, and market conditions on the liquidity of any FCS bank,[11] we now propose amendments to § 615.5134 that would redress these vulnerabilities.

III. Section-by Section Analysis of the Proposed Rule

A. Section 615.5134(a) – Liquidity Policy

The board of directors is responsible for ensuring that the bank always has readily available funds to continue operations and pay maturing obligations. The board discharges this responsibility by adopting policies and procedures for management to follow. A provision in the existing investment management regulation, § 615.5133(c)(3), requires FCS banks to address liquidity risk in their investment policies. However, the only affirmative requirement that § 615.5133(c)(3) imposes on FCS banks is that their investment policies must describe the liquidity characteristics of eligible investments that they hold to meet their liquidity needs and institutional objectives. Although the existing regulation gives FCS banks ample flexibility to formulate liquidity policies that meet their particular needs and objectives, the FCA is proposing to add a new paragraph (a) to § 615.5134 that for the first time, would require each FCS bank to address other specific issues in its liquidity policies. The banks have the option of either incorporating these new liquidity policies in their investment management policies required under § 615.5133, or in a separate document.

Proposed § 615.5134(a) addresses the board's responsibility for establishing and implementing liquidity policies for the bank. Proposed § 615.5134(a)(1) would require the board of directors of each FCS bank to adopt written liquidity policies that are consistent with the investment management policies that the board adopts under § 615.5133. The guidance that the FCA has provided to FCS banks about investment management policies and practices in § 615.5133 also applies to their liquidity policies.[12] The FCA expects the bank's liquidity policies to be consistent with, and fit into its overall investment strategy. Liquidity risk management is critically important to the long-term viability of the bank, and for this reason, it must be integrated into the bank's overall investment management and risk management processes.[13]

In discharging its responsibility, the board must establish appropriate strategies, policies, procedures, and limits that will enable the bank to monitor, measure, manage, and mitigate liquidity risk.[14] The board's policy should provide adequate guidance to management as it develops and implements strategies for managing liquidity risk. At a minimum, the policy should provide clear direction to management about limiting and controlling risk exposures, and keeping them within the board's risk tolerance levels. Additionally, these policies should establish parameters that enable management to determine whether particular investments belong in the liquidity reserve given their potential suitability for managing interest rate risks.

Proposed § 615.5134(a)(1) would also require the board to: (1) Review its liquidity policies at least once every year; (2) affirmatively validate the sufficiency of its liquidity policies; and (3) make any revisions it deems necessary. The purpose of this provision is to compel every FCS bank board to ascertain whether its policies enable the bank to respond promptly and effectively to events that may occur and threaten its liquidity. More specifically, the board should determine, as part of its review, whether its current policies enable the bank to consistently maintain sufficient liquidity for its ongoing funding needs, thus covering both expected and unexpected deviations in the availability of funds to meet cash demands.[15] A bank's viability often depends on effective liquidity risk management (that is fully integrated into its overall risk management strategies and processes), and the annual review should determine whether the policies achieve these objectives.[16] As part of its review, the bank board should consider whether it needs to adjust its liquidity policies based both on past experiences and on expected trends in the economy, agriculture, and financial markets.

The final provision of proposed § 615.5134(a)(1) would require the board to ensure that adequate and effective internal controls are in place, and that management complies with and carries out the bank's liquidity policies. Besides preventing losses caused by fraud or mismanagement, strong internal controls will enable FCS banks to respond more quickly and effectively when significant market turmoil arises and impedes access to funding.

The content of the board's liquidity policies are the focus of § 615.5134(a)(2). This regulatory provision identifies seven different issues that, at a minimum, a bank must address in its liquidity policies. The bank's policies should be comprehensive and commensurate with the complexity of the bank's operations and risk profile.

Proposed § 615.5134(a)(2)(i) would require policies to address the purpose and objectives of the liquidity reserve. This section of the bank's policies should distinguish the purpose and objectives of the liquidity reserve from the other operations and asset-liability functions of the bank, including interest rate management. The board's philosophy and position on the purpose and objectives of the liquidity reserve are of prime importance to effective liquidity management at the bank. In normal times, access to the debt markets provides the System with ready liquidity. However, when market access is impeded, the liquidity reserve should enable each FCS bank to maintain sufficient cashflows to pay its obligations, meet its collateral needs, and fund operations in a safe and sound manner.[17]

In normal times, FCS banks may pay more attention to the financial performance of the liquidity reserve rather than its role as an emergency source of funding. Incorrectly prioritizing these two objectives is problematic because the liquidity reserve should consist of cash and high-quality investments that can be quickly converted into cash at, or close to, par value. Cash-like investments pose little risk to the investor and, therefore, they usually do not earn the highest rate of return.

During the crisis in 2008, some FCS banks experienced losses that were larger than expected given the primary purpose of the liquidity reserve is an emergency source of funding. The FCA expects FCS banks to select investments for the liquidity reserve by their liquidity characteristics, and to match these assets closely to the bank's maturing liabilities. Choosing investments primarily for their ability to generate revenue is fundamentally incompatible with the System's GSE status.[18] Pursuant to proposed § 615.5134(a)(2)(i), the board should provide guidance to management about these issues when it addresses the objectives and purposes of the liquidity reserve in its policies.

Proposed § 615.5134(a)(2)(ii) would require the board's policies to address the diversification of the liquidity reserve portfolio. This diversification requirement would apply to both the liquidity reserve in proposed § 615.5134(e) and the supplemental liquidity buffer in proposed § 615.5134(f). Diversification by tenor, issuer, issuer type, size, asset type, and other factors can reduce certain investment risks. The bank's diversification policy should address the board's desired mix of cash and investments that the bank should hold for liquidity under a variety of scenarios, including both normal and adverse conditions. Within the spectrum of eligible qualified investments, proposed § 615.5134(a)(2)(ii) would require the policy to establish criteria for diversifying these assets based on issuers, maturity, and other factors that the bank deems relevant. In formulating these criteria, each bank should consider, in light of its needs and circumstances, how diversification would better enable the liquidity reserve and supplemental liquidity buffer to serve as its emergency or supplemental funding source when market access is curtailed or fully impeded. The FCA expects each bank to tailor its policy to its individual circumstances and financial conditions, and to revise it in response to changes in the business environment.

Proposed § 615.5134(a)(2)(iii) would require the board's policies to establish maturity limits and credit quality standards for investments that the bank is holding in its liquidity reserve. This aspect of the bank's policies would help management to target and match cash inflows from loans and investments to outflows that pay its maturing obligations. In devising its diversification strategy the bank should consider how it may need to rely on its liquidity portfolio as an available funding source in the short-, intermediate-, and long-term. As high-quality investments season and come closer to maturity, they become more liquid. In this context, a well-reasoned policy should guide management about deploying the strata of investments throughout the liquidity reserve and the supplemental liquidity buffer.

Proposed § 615.5134(a)(2)(iii) also focuses on the credit quality standards that board policies should establish for investments that the bank will hold to meet the liquidity reserve requirements of this regulation. Investments with short terms to maturity and high credit quality tend to be liquid and, therefore, are generally suitable for the bank's liquidity reserve and supplemental liquidity buffer. The preamble to § 615.5134(c) below, will discuss many of the attributes of high-quality liquidity investments in greater detail. The bank's liquidity policies should base credit quality standards for investments on factors and standards that the financial services industry uses to determine that the risk of default for both the asset and its issuer are negligible. In determining the credit quality of a security, FCS banks may consider the credit ratings issued by a Nationally Recognized Statistical Rating Organization (NRSRO), but may not rely solely or disproportionately on such ratings. System banks must document their credit quality determinations.

Under proposed § 615.5134(a)(2)(iv), the board's policies should cover the target amount of days of liquidity that the bank needs based on its business model and its risk profile. Estimating the target amount of days of liquidity that the bank will need to outlast various stress events is an effective tool for managing and mitigating liquidity risks. The FCA expects each FCS bank to include a prudent amount of unfunded commitments in its calculation of the target amount of days of liquidity it will need to survive a liquidity crisis in the markets.

Proposed § 615.5134(a)(2)(v) would require the bank's policies address the elements of the Contingency Funding Plan (CFP) in paragraph (h) of the proposed rule. The purpose of the CFP is to address unexpected events or unusual business conditions that increase liquidity risk at FCS banks. Our existing regulation, § 615.5134(d), requires each FCS bank to have a formal written CFP to address liquidity shortfalls that may occur during market disruptions. The proposed rule would strengthen contingency funding planning at FCS banks. Under proposed § 615.5134(a)(2)(v), an effective CFP would cover at a minimum: (1) Strategies, policies, and procedures to manage a range of stress scenarios; (2) chains of communications and responsibility within the bank; and (3) implementation of the CFP during all phases of an adverse liquidity event. The preamble to proposed § 615.5134(h) will discuss the substantive requirements of the CFP and our expectations of FCS banks in greater detail.

The next provision of this regulation, proposed § 615.5134(a)(2)(vi), covers delegations of authority pertaining to the liquidity reserve in the bank's liquidity policies. As with all other aspects of the bank's operations, an explicit delegation of authority within a clearly defined chain of command strengthens the effectiveness and efficiency of an institution's operations and mitigates the risk of loss. The purpose of a delegation of authority is to clearly establish lines of authority and responsibility for managing the bank's liquidity risk.[19] The policies should clearly identify those individuals and committees that are responsible for making decisions involving liquidity risk and implementing risk mitigation strategies. Additionally, the policies should ensure that the ALCO has sufficiently broad representation across the operational functions of the bank that influence the bank's liquidity risk profile.

Under proposed § 615.5134(a)(2)(vii), the policies must contain reporting requirements, which at a minimum, would require management to report to the board at least once every quarter about compliance with the bank's liquidity policies, and to what extent the liquidity reserve portfolio has achieved the bank's liquidity objectives. This provision would also require management to report immediately to the board about any deviation from its liquidity policies, or any failure to meet the liquidity targets in the board's policies. The purpose of this provision is to ensure that an effective reporting process is in place, and management communicates accurate and timely information to the board about the level and sources of the bank's exposure to liquidity risk. These reports should enable the board to take prompt corrective action. The board should also consider these quarterly reports when it conducts its annual review of the bank's liquidity policies and decides whether to make any revisions to its policies, pursuant to proposed § 615.5134(a)(1).

B. Liquidity Reserve Requirement - § 615.5134(b)

Proposed § 615.5134(b) is the cornerstone of the FCA's proposal because it articulates the core liquidity reserve requirements for FCS banks. Proposed § 615.5134(b) is not a departure from the liquidity reserve requirement in FCA's existing liquidity regulation. Instead, it builds upon and strengthens the concepts, principles, and requirements of existing § 615.5134. The purpose of proposed § 615.5134(b) is to better prepare FCS banks so they can withstand future liquidity crises. The FCA designed this proposal to address the vulnerabilities identified during recent crises. In developing proposed § 615.5134(b), we also considered the Basel Committee's recommendations for an international framework for liquidity, and the Federal banking agencies' Interagency Policy Statement on Funding and Liquidity Risk Management.

Both the existing and proposed regulations require each FCS bank to maintain a liquidity reserve sufficient to fund 90 days of the principal portion of maturing obligations and other borrowings of the bank at all times. However, in contrast to the existing regulation, proposed § 615.5134(b) and (e) would divide the bank's liquidity reserve into two levels. The first level of the liquidity reserve would fund a bank's maturing obligations and operations for the first 30 days from the onset of a significant stress event. Cash and certain instruments that mature within 3 years or less must comprise at least 15 days of the first level of the bank's liquidity reserve. The bank would draw on the second level of the reserve if market turmoil continued to persist for the subsequent 60 days after the initial 30 days thereby comprising together a stratified 90-day liquidity reserve.

Proposed § 615.5134(b) would require FCS banks, for the first time, to maintain a supplemental liquidity buffer pursuant to proposed § 615.5134(f). The new regulation would require each FCS bank to hold supplemental liquid assets (comprised of cash and other qualified assets listed in § 615.5140) in excess of the 90-day minimum liquidity reserve. The supplemental liquidity buffer would complement the 90-day liquidity reserve, and its purpose is to enable each FCS bank to continue operations if market access becomes impeded for a prolonged period of time in differing stress scenarios.

Proposed § 615.5134(b) would also require FCS banks to discount the assets in their liquidity reserve by the percentages specified in proposed § 615.5134(g). Although the existing regulation already requires FCS banks to discount assets in the liquidity reserve, the proposed rule would change some of the percentages to reflect the new two-tier structure of the liquidity reserve. The preamble to proposed § 615.5134(g) discusses in detail how we are revising the discounting requirements for the liquidity reserve.

The final sentence of proposed § 615.5134(b) states that the liquidity reserve must be comprised only of cash, including cash due from traded but not yet settled debt, and qualified eligible investments under § 615.5140 that are marketable under proposed § 615.5134(d). Proposed § 615.5134(b) is similar, but not identical, to existing § 615.5134(a). Both the existing and the proposed rule specify that the liquidity reserve must be comprised of cash, including cash due from traded but not yet settled debt, and investments listed in § 615.5140.

The final sentence of proposed § 615.5140(b), however, differs from existing § 615.5140(a) in two crucial respects. First, the proposed rule emphasizes that all investments held in liquidity reserves must be marketable. As the preamble to proposed § 615.5134(d) explains in greater detail below, the new regulation would establish specific regulatory benchmarks for determining whether particular investments are marketable. Marketability of a security is an essential attribute of its liquidity and helps determine its suitability for the liquidity reserve.

Second, the proposed rule would repeal the provisions in existing § 615.5134(a) that impose specific credit ratings on investments that FCS banks hold in their liquidity reserves. Under the existing regulation, money market instruments and floating and fixed rate debt securities held in the banks' liquidity reserve must maintain one of the two highest NSRSO credit ratings. In the event that an unrated instrument is in the liquidity reserve, the existing regulation requires the issuer to carry one of the two highest NRSRO ratings. Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act[20] requires each Federal agency to: (1) Review any references or requirements in its regulations concerning the credit ratings of securities and money market instruments, and (2) replace references to, and requirements that regulated entities rely on such credit ratings with standards of creditworthiness that the agency determines is appropriate. In making this determination, every agency must seek to establish, to the extent feasible, uniform standards of creditworthiness. Our proposed liquidity regulation does not seek to replace the NRSRO rating requirements in existing § 615.5134(a) with a specific alternate standard of creditworthiness. Instead, we propose to require FCS banks to hold investments in the liquidity reserve that are unencumbered under proposed § 615.5134(c), and are marketable under proposed § 615.5134(d). In two other rulemakings, the FCA has invited the public to suggest options for replacing NRSRO credit ratings with other standards to determine the creditworthiness of financial instruments and their issuers.[21] We also solicit your comments and suggestions about the best approach for addressing standards of creditworthiness for investments held in the liquidity reserves of FCS banks.

C. <u>Unencumbered and Marketable Investments in the Liquidity Reserve</u>

Currently, existing § 615.5134(b) states that all investments that an FCS bank holds for the purpose of meeting its regulatory liquidity reserve requirement must be free of lien. Proposed § 615.5134(c) would expand upon this concept by requiring FCS banks to hold only unencumbered investments in their liquidity reserves. Under proposed § 615.5134(c), an asset is unencumbered if it is free of lien and is not explicitly or implicitly pledged to secure, collateralize, or enhance the credit of any transaction.[22] Additionally, proposed § 615.5134(c) also would prohibit any FCS bank from using an investment in the liquidity reserve as a hedge against interest rate risk pursuant to § 615.5135 if liquidation of that particular investment would expose the bank to a material risk of loss. Unencumbered investments are free of the impediments or restrictions that would otherwise curtail the bank's ability to liquidate them to pay its obligations when normal access to the debt market is obstructed. Proposed § 615.5134(c) strengthens the liquidity of FCS banks and improves the safety and soundness of the Farm Credit System as a whole.

Under both proposed § 615.5134(b) and (d), all eligible investments that FCS banks hold in their liquidity reserves must be marketable. Proposed § 615.5134(d) specifies the criteria and attributes that determine whether investments are marketable for the purposes of this regulation. Investments that meet all the marketability criteria in proposed § 615.5134(d) would be deemed to possess the characteristics of high-quality liquid assets that are suitable for the liquidity reserves at FCS banks. Proposed § 615.5134(d) is based on many of the concepts that the Basel Committee articulated in the Basel III Liquidity Framework.[23] The FCA tailored these concepts to the unique structure, needs, and circumstances of the FCS.

Proposed § 615.5134(d)(1) states that an investment is marketable if it can be easily and immediately converted into cash with little or no loss in value. Investments that exhibit this attribute are more likely to generate funds for the bank without incurring steep discounts even if they were liquidated in a "fire sale" during turmoil in the markets.[24] The liquidity of an asset depends on its performance during a stress event, and is measured by the amount that the holder can convert into cash within a certain timeframe.[25]

On a related note, proposed § 615.5134(d)(1) complements the definition of "liquid investments" in existing § 615.5131(e).[26] The existing regulation defines "liquid investments" as "assets that can be promptly converted into cash without significant loss to the investor.[27] We do not consider § 615.5131(e) to be redundant or inconsistent with proposed § 615.5134(d)(1). For this reason, we do not propose to repeal or amend § 615.5131(e). However, we invite your comments about whether the final rule should retain, relocate, or modify § 615.5131(e).

Another feature of a marketable investment is that it exhibits low credit and market risks, and we propose to incorporate this criterion into proposed § 615.5134(d)(2). Assets tend to be more liquid if they are less risky. An investment has low credit risk if its issuer has a strong credit standing, is not heavily indebted, and its assets are not heavily leveraged. Low duration[28] and low volatility indicate that an investment is more likely to be liquid because it has low market risk.[29]

Ease and certainty of valuation is also an attribute of marketable investments.[30] We are incorporating this concept into proposed § 615.5134(d)(3). The liquidity of an asset is likely to increase if market participants are able to agree on its valuation. An instrument has ease and certainty of valuation if the components of its pricing formulation are publicly available. The pricing of high-quality liquid assets are usually easy to calculate because they do not depend significantly on numerous assumptions. In practice, proposed § 615.5134(d)(3) effectively excludes structured investments from the liquidity reserves at FCS banks, although banks may hold such assets in their supplemental liquidity buffers if they are eligible investments under § 615.5140. The proposed rule, however, would allow FCS banks to hold mortgage-backed securities issued by the Government National Mortgage Association in their liquidity reserves because they are highly marketable securities backed by the full faith and credit of the United States.

Under proposed § 615.5134(d)(4), the final attribute of a marketable investment is that it can be easily bought or sold. Money market instruments generally qualify as marketable investments under this provision because they are easily bought and sold even though they are not traded on exchanges. Otherwise, marketable investments include assets listed on developed and recognized exchange markets. Listing on a public exchange enhances the transparency of the pricing mechanisms of investments, thus enhancing their marketability and liquidity.[31] Investments would also comply with the requirement of proposed § 615.5134(d)(4) if investors can sell or convert them into cash through repurchase (repo) agreements in active and sizeable markets. For the purpose of this proposed rule, markets are active and sizeable if they have a large number of market participants, high-trading volume, and investors can sell or repo the asset at any time.[32] Many securities that System banks hold in their liquidity reserves are traded in high volume. Nevertheless, the FCA cautions that the potential volume that an FCS bank trades or holds in a particular security should not constitute a significant percentage of the overall trading volume in that security. Another feature of an active and sizeable market is that it historically has market breadth and market depth.[33] Proposed § 615.5134(d)(4) would exclude private placements from the banks' liquidity reserves, but not the supplemental liquidity buffer.

D. Composition of the Liquidity Reserve

Proposed § 615.5134(e) governs the composition of the liquidity reserve. This provision would require each FCS bank to continuously hold cash and the investments identified in the table to proposed §

615.5134(e) to meet the 90-day minimum liquidity reserve requirement of this regulation. Under this proposal, each bank would also apply the discounts in proposed § 615.5134(g) to all cash and investments that it holds in its liquidity reserve.

Although the existing regulation already requires every FCS bank to maintain a sufficient stock of liquid assets to fund its maturing obligations and other borrowings for at least 90 days, the proposed rule would divide the liquidity reserve into two levels. The first level of the liquidity reserve would provide sufficient liquidity for the bank to pay its obligations and continue operations for 30 days, whereas the second level of the reserve would cover the following 60 days. Taken together, the two levels of the liquidity reserve should provide each FCS bank with adequate liquidity for 90 days.

Proposed § 615.5134(e) would require FCS banks to hold a minimum of 90 days of cash and liquid investments in their liquidity reserves. In other words, FCS banks may need to exceed 90 days based on their individual liquidity needs. The FCA expects each bank, in accordance with its policies and procedures, to determine the appropriate level, size, and quality of its liquidity reserve based on its liquidity risk profile. Determining and maintaining an adequate level of liquidity depends on each bank's ability to meet both expected and unexpected cash flows and collateral needs without adversely affecting its daily operations and financial condition.[34] Additionally, the size and level of the liquidity reserve should correlate to the bank's ability to fund its obligations at reasonable cost.[35] Each FCS bank must document and be able to demonstrate to FCA examiners how its liquidity reserve mitigates the liquidity risk posed by the bank's business mix, balance sheet structure, cash flows, and on- and off-balance sheet obligations.[36] Matching the size, level, and composition of the liquidity reserve to obligations that are maturing in a prescribed number of days is a sound banking practice, and is consistent with GSE status.

The proposed rule would require each FCS bank to maintain sufficient quantity of highly liquid assets in the first level of its liquidity reserve so it could continue normal operations for 30 days if a national security emergency, a natural disaster, or intense economic or financial turmoil impedes System access to the markets. As the first item in the left column of the table states, investments in the first level of the liquidity reserve would be available for the bank to sequentially apply to pay obligations that mature starting on day 1 through day 30.

Under the second provision in the left-hand column of the table, cash and instruments with a final maturity of 3 years or less must comprise at least 15 days of the first level of the liquidity reserve. As a result, the proposed rule would mandate that each bank have enough cash and short-term, highly liquid assets on hand so it could pay its obligations and fund its operations for 15 days if the debt markets were closed, or the System's cost of funding became uneconomical. FCS banks would draw first on this 15-day sublevel in the event of significant stress event.

The right side of the table identifies the assets that proposed § 615.5134(e) would require FCS banks to hold in Level 1 of their liquidity reserves. Again, all of these assets are highly liquid because they are cash, or investments that are high quality, close to their maturity, and marketable. All of the assets that banks hold in their liquidity reserve would be subject to the discounts specified in proposed § 615.5134(g).

Under the proposed rule, FCS banks are authorized to hold five classes of assets in the first level of their liquidity reserve. These assets are:

- Cash –
  (1) Cash balances on hand,
  (2) Cash due from traded but not yet settled debt, and

(3) Insured deposits that FCS banks hold at federally insured depository institutions in the United States;

- United States Treasury securities –
  Each FCS bank must select Treasury securities that have final maturities and other characteristics that best enables it to fund operations if market access becomes obstructed;

- Other marketable obligations explicitly backed by the full faith and credit of the United States;[37]

- Government-sponsored agency senior debt securities that mature within 60 days (debt obligations of the FCS are excluded);[38]

- Diversified investment funds that are comprised exclusively of Level 1 instruments.

As discussed earlier, the second level of the liquidity reserve would provide FCS banks with sufficient liquidity to fund their obligations and continue normal operations starting on day 31 through day 90. Under proposed § 615.5134(e), FCS banks would use the assets in Level 2 during a prolonged stress event to fund obligations that mature during the subsequent 60 days of the 90-day liquidity reserve.

The proposed rule would authorize FCS banks to hold the five following classes of assets in the second level of their liquidity reserves:

- Additional amounts of Level 1 instruments;
- Government-sponsored agency senior debt securities with maturities that exceed 60 days;[39]
- Government-sponsored agency mortgage-backed securities;
- Money market instruments that mature in 90 days; and
- Diversified investment funds that are comprised exclusively of Levels 1 and 2 instruments.

Unfunded commitments are another issue that raises concerns for the FCA. FCS banks or their affiliated associations often have outstanding lines of credit to borrowers who may draw funds to meet their seasonal business needs. FCS banks and associations can be legally obligated to fund these commitments. A sudden surge in borrower demand for funds under these lines may impair the bank's liquidity at a time when market access is becoming impeded. For this reason, it is important that FCS banks adequately account for unfunded commitments and other contingencies, including those that are off balance sheet, when they calculate the amount and quality of liquid assets they need in their liquidity reserve to fund all maturing and contingent obligations during a particular time period. Each FCS bank has its own unique circumstances and risk profile and, therefore, exposure to unfunded commitments and other contingent obligations varies within the FCS.

Unfunded commitments and other material contingent obligations, including those off balance sheet, potentially expose both FCS and other financial institutions to significant safety and soundness risks. Accordingly, contingent outflows raise substantial regulatory concerns for the FCA and other financial regulators.[40] Proposed § 615.5134(e) does not specifically require FCS banks to maintain sufficient assets in the liquidity reserve to cover unfunded commitments and other contingent obligations. However, the FCA is contemplating whether to add a specific provision to the final regulation that would require the liquidity reserve to adequately cover unfunded commitments and other contingent obligations. Requiring FCS banks to hold sufficient liquidity to cover these contingencies could mitigate risks that pose a threat to the liquidity, solvency, and ultimate viability of FCS banks. However, such a requirement could also impose significant opportunity costs on FCS banks in that they would be compelled to provide for these contingencies with cash and short-term liquid investments.

The FCA considers the guidance of the Federal banking agencies and the Basel III Liquidity Framework in developing this proposed rule on liquidity, and evaluates whether it is appropriate for System banks. Specifically, the Basel Committee currently suggests that regulated entities account for unfunded commitments and other contingent obligations in their liquidity reserve calculations. We are evaluating to what extent we should incorporate the approach of the Basel III Liquidity Framework into our regulation.

For this reason, we solicit your responses to the following questions:

- Should the final rule explicitly require the liquidity reserve to cover unfunded commitments and other contingent obligations? In your opinion, what would be the advantages and disadvantages of adding this requirement to § 615.5134(e)?
- Should the FCA consider more stringent liquidity reserve requirements based on size and complexity of different FCS banks, or should the liquidity reserve requirements remain the same for all System banks?
- What cash inflows and outflows identified in the Basel III Liquidity Framework are relevant to System banks? For those that are relevant, how should we incorporate them into our regulation?
- Should we incorporate the Basel III Liquidity Framework stress parameters in the liquidity reserve requirement for System banks? If so, which ones? For those, please indicate what percentage of the unfunded commitments and other contingent obligations the FCS bank should cover in its liquidity reserve.
- How should an association's direct loan under the General Financing Agreement and its accompanying contingent commitments factor into the funding bank's liquidity reserve requirement?

Please provide any information or data concerning unfunded commitments and other contingent obligations that support your answers to the above questions.

E. Supplemental Liquidity Buffer

Proposed § 615.5134(f) would introduce a new concept into the FCA's liquidity regulation by requiring all FCS banks to establish and maintain a supplemental liquidity buffer that would provide a longer term, stable source of funding beyond the 90-day minimum liquidity reserve. The supplemental liquidity buffer would complement the 90-day minimum liquidity reserve. Whereas the primary purpose of the 90-day minimum liquidity reserve is to furnish sufficient short-term funding to outlast an immediate crisis, the supplemental liquidity buffer would enable FCS banks to manage and mitigate their liquidity risk over a longer term horizon. Besides providing FCS banks with longer term and stable source of funding, each bank would be able to draw on the supplemental liquidity buffer if a heavy demand for funds strains its 90-day minimum liquidity reserve during a significant stress event. The supplemental liquidity buffer is an additional stock of assets that would provide stable, longer term funding of the bank's operations beyond the first 90 days.

The proposed rule does not specify the length of time that the supplemental liquidity buffer should cover. The Basel Committee on Banking Supervision recommends that a supplemental reserve should provide depository institutions and related banking organizations stable, long-term funding over a 1-year time horizon. We invite your comments about whether our final rule should establish a specific time horizon for the supplemental liquidity buffer at FCS banks. If you believe that we should establish a specific timeframe for the supplemental liquidity buffer, please tell us what you think it should be, and why. If you oppose a specific regulatory time horizon for the supplemental liquidity buffer, please explain your reasoning. We are also interested in hearing your views about how the similarities and differences between FCS banks and financial institutions under the supervision of other Federal and international regulators influence the answers to our questions about potential time horizons for the supplemental liquidity buffers at FCS banks.

The first sentence of proposed § 615.5134(f) would require each Farm Credit bank to hold supplemental liquid assets in excess of the 90-day minimum liquidity reserve. Again, the supplemental liquidity buffer consists of the amount of stable longer term funding that a FCS bank has available, and it should match the amount of stable funding that the bank needs to operate during a prolonged period of time. For the purposes of proposed § 615.5134(f), stable funding means that the instruments in the supplemental liquidity buffer are expected to furnish the bank with a reliable source of funds over a longer term time horizon under conditions of extended stress. The amount and composition of the supplemental liquidity buffer at a particular bank ultimately depends on a number of different factors pertaining to its operations, including the funding of its assets and liabilities, off-balance sheet items, and contingent exposure, such as unfunded commitments.

According to the second sentence of proposed § 615.5134(f), the supplemental liquidity buffer must be comprised of cash and qualified eligible investments listed in § 615.5140 of this part. Thus, the proposed rule would allow FCS banks to hold qualified eligible investments (listed in § 615.5140) in their supplemental liquidity buffer that they could not hold in their 90-day liquidity reserve. However, the FCA expects each FCS bank to calibrate the quality and quantity of assets that it selects for the supplemental liquidity buffer to the amount of funding it will need to outlast significant stress scenarios. Each bank should configure its supplemental liquidity buffer so it realistically corresponds to the demands of its liquidity risk profile.

The third sentence of proposed § 615.5134(f) states that each FCS bank must be able to liquidate any qualified investment in its supplemental liquidity buffer within the timeframe established in the bank's liquidity policies at no less than 80 percent of its book value. The fourth sentence of proposed § 615.5134(f) would require an FCS bank to remove from its supplemental liquidity buffer any investment that has, at any time, a market value that is less than 80 percent of its book value. These two provisions are designed to limit loss that the bank might incur on qualified investments that it holds in its supplemental liquidity buffer. From the FCA's perspective, the liquid and marketable characteristics of qualified investments in the supplemental liquidity buffer would be called into question if their market value falls 20 percent or more below their book value. In all probability, an FCS bank could no longer convert such assets easily or immediately into cash at little or no loss in value. Additionally, a qualified investment that has lost 20 percent or more of its book value no longer exhibits low credit or market risks. The proposed rule would instill strong discipline and control by requiring FCS banks to remove from their supplemental liquidity buffer an investment that has depreciated 20 percent or more off its book value. We invite your comments on the maximum percentage that the final rule should allow the market value of an asset to depreciate from its book value before the bank must remove it from the supplemental liquidity buffer.

Finally, proposed § 615.5134(f) would require the amount that each bank holds in its supplemental liquidity buffer, at a minimum, to: (1) Adhere to the requirements of the board's liquidity policies; (2) provide excess liquidity beyond the days covered by the 90-day minimum liquidity reserve; and (3) enable the bank to meet the needs of its CFP. The supplemental liquidity buffer is a stable longer term funding source that enables each bank, based on its business and risk profiles, to match the inflow and outflow of funds from its assets and liabilities.

F. Discounts

Our existing liquidity regulation requires FCS banks to discount assets in their liquidity reserves. Existing § 615.5134(c) specifies the discount percentage that applies to particular classes of assets. We propose to revise the provision in the rule pertaining to discounts so they are more appropriate to the new regulatory structure, which splits the liquidity reserve into two levels, establishes a supplemental liquidity buffer, and greatly strengthens contingency funding planning at FCS banks.

Discounts approximate the cost of liquidating investments over a short period of time during adverse situations. The system of discounting assets is designed to accurately reflect true market conditions. For example, the proposed rule would assign only a minimal discount to investments that are less sensitive to interest rate fluctuations because they are exposed to less price risk. Conversely, the discount for long-term fixed rate instruments is higher because they expose FCS banks to greater market risk.

Accordingly, the FCA proposes the following discounts for the classes of assets that FCS banks hold in their liquidity reserves and supplemental liquidity buffers:

Instrument	Multiply by
Cash and overnight investments	100 percent
United States Treasuries	97 percent of market value
All other Level 1 instruments including such instruments held in Level 2 to fund obligations maturing on day 31 through day 90	95 percent of market value
All Level 2 instruments	93 percent of market value
All other qualified investments held for meeting the bank's liquidity policy and contingency plans unless they merit the discount for Level 1 or Level 2 instruments	85 percent of market value

G. <u>Contingency Funding Plan</u>

Contingency funding planning is an essential and crucial element of effective liquidity risk management at all financial institutions. The CFP is a blueprint that helps financial institutions respond to contingent liquidity events, which are unexpected events or conditions that may increase liquidity risk.[41] Contingent liquidity events may arise from external factors that adversely affect the financial system, or they may be specific to the conditions at an individual institution.[42]

Since 2005, our regulation has required all FCS banks to have a contingency funding plan that addresses liquidity shortfalls during market disruptions. Existing § 615.5134(d) also requires the board of directors of each FCS bank to review the contingency funding plan every year and make any necessary changes. The crisis in 2008 revealed actual and potential vulnerabilities in contingency planning at FCS banks. As a result, the FCA proposes to strengthen contingency planning at FCS banks by amending the applicable provisions of our liquidity regulation. These amendments should reinforce the wherewithal of FCS banks to withstand future crises.

The first sentence of proposed § 615.5134(h) would require each FCS bank to have a CFP to ensure sources of liquidity are sufficient to fund normal operations under a variety of stress events. Whereas existing § 615.5134(d) only requires the CFP to address liquidity shortfalls caused by market disruptions, proposed § 615.5134(h) would require the CFP to explicitly cover other stress events that threaten the bank's liquidity. In addition to market disruptions, the proposed rule would require the CFP to specifically address:

(1) Rapid increases in loan demand;
(2) Unexpected draws on unfunded commitments;
(3) Difficulties in renewing or replacing funding with desired terms and structures;
(4) Pledging collateral with counterparties; and
(5) Reduced market access.

Each of these events could weaken the bank's liquidity and impair its access to funding during a crisis.

The second sentence of proposed § 615.5134(h) would require each Farm Credit bank to maintain an adequate level of unencumbered and marketable assets in its liquidity reserve that could be converted into cash to meet its net liquidity needs based on estimated cash inflows and outflows for a 30-day time horizon under an acute stress scenario. As an integral and critical part of contingency planning, each FCS bank should quantitatively project and evaluate its expected funding needs and its available funding sources during likely stress scenarios. More specifically, each FCS bank must realistically assess and analyze its cash inflows, cash outflows, and its access to funding at different phases of a potential, but acute liquidity stress event that continues for 30 days. In addition to a realistic assessment of potential cash-flow mismatches that may occur during different intervals of various stress events, effective contingency planning also requires the bank to evaluate whether it has a sufficient amount of marketable assets that it can convert into cash and continue operations for the duration of any potential crisis.

The next provisions of proposed § 615.5134(h) would require the CFP to address four specific areas that are essential to the bank's efforts to mitigate its liquidity risk. Taken together, these four provisions require each bank to have an emergency preparedness plan in place so it can effectively cope with a full range of contingencies that could endanger its liquidity, solvency, and viability.

First, proposed § 615.5134(h)(1) would require each FCS bank to customize the CFP to its individual financial condition and liquidity risk profile and the board's liquidity risk tolerance policy. The CFP is part of the bank's overall liquidity policies, and as such, it should be commensurate with the complexity, risk profile, and scope of the bank's operations.[43] The CFP should cover a number of plausible scenarios that could adversely affect the bank's liquidity. In this context, the CFP should address contingencies that are both:

- Highly probable, but would have a low impact on the bank's liquidity; and
- Less likely to occur but would have a significant impact on the bank's liquidity.[44]

The CFP should identify stress events that could have a significant impact on the bank's liquidity based on its individual circumstances, such as its balance sheet structure, business model, and organizational configuration.[45] The CFP should also assess how different stress events are likely to affect the bank's liquidity.

Under proposed § 615.5134(h)(2), the CFP must identify funding alternatives that the Farm Credit bank can implement whenever its access to funding is impeded. For the purposes of proposed § 615.5134(h)(2), funding alternatives include, at a minimum, arrangements for pledging collateral to secure funding and possible initiatives to raise additional capital. Each bank must be able to readily access its contingent funding sources during a stress event. The FCA expects every FCS bank to take appropriate measures, including advance planning and periodic testing, so it always has reliable funding alternatives available when normal market access becomes impeded.

Pursuant to proposed § 615.5134(h)(3), the CFP must require the bank to conduct periodic stress testing in order to analyze the possible impacts on the bank's cash inflows and outflows, liquidity position, profitability and solvency under a variety of stress scenarios. Periodic stress testing of its anticipated cash flows would enable the bank to estimate future funding surpluses and shortfalls under several different stress scenarios, which in turn, affects the bank's ability to fund its assets, liabilities, and operations throughout adverse situations.

Proposed § 615.5134(h)(4) would require each bank's CFP to establish a process for managing events that imperil its liquidity. This includes assigning appropriate personnel and having executable action plans to implement the CFP. Under this provision, the CFP would establish a framework for the bank to monitor contingent events that potentially threaten its liquidity. This framework should contain mechanisms, such as early-warning indicators and event triggers,[46] which are tailored to the bank's liquidity profile. These early-warning systems help the bank to identify potential adverse liquidity events that are looming on the horizon. This enables the bank to position itself and be ready for the various phases of the stress event as it evolves.

The second prong of proposed § 615.5134(h)(4) involves internal controls and management of contingency events. The CFP should establish a reliable crisis management team. Frequent communication and reporting among team members, management, and the board optimize the effectiveness of the CFP during a liquidity crisis by coordinating the bank's response and diminishing liquidity risks to the bank's operations.[47] The CFP should also identify the processes and procedures that the bank will use to manage any evolving crisis.

The final sentence of proposed § 615.5134(h) would require the board of directors of each FCS bank to review and approve the CFP at least once every year, and incorporate adjustments to reflect changes in the bank's risk profile and market conditions. Internal conditions and the external environment in which the FCS operates may shift, either gradually or suddenly, thus affecting the liquidity risk profile of each bank. The FCA expects each FCS bank to constantly monitor fluctuations in its operating environment and react effectively so it can quickly stem potential damage to its liquidity, solvency, and viability. Reviewing the CFP at least once every 12 months and more frequently as conditions warrant, is a necessary tool for FCS banks to manage and mitigate its liquidity risk.

H. The FCA's Reservation of Authority

In addition to capital, asset quality, management, earnings, and interest rate sensitivity, liquidity is a prime barometer of the financial health, vitality, and viability of financial institutions. Illiquidity indicates that a financial institution is in an unsafe and unsound condition. More than the other indicia of safety and soundness, liquidity is often, but not always, determined by external factors that are beyond the control of FCS banks and other financial institutions. For example, a national defense emergency (such as terrorist attacks), a catastrophic natural disaster, or a macroeconomic or financial crisis could suddenly and without warning close or impede access to the debt markets that FCS banks depend on to fund their normal operations.

Congress designated the FCA as the Federal agency that is responsible for ensuring that all FCS institutions: (1) Comply with all applicable laws; (2) fulfill their public policy mission of extending credit to agriculture, rural utilities, and rural homeowners; and (3) operate safely and soundly. As a result, the Act grants the FCA comprehensive examination, enforcement, and regulatory powers to carry out these duties. The System's liquidity could come under sudden strain when economic uncertainty sparks financial turmoil and, therefore, the FCA must be able to act decisively so all FCS banks meet their obligations and continue operations until the crisis subsides. The FCA has various tools at its disposal to lessen the damage that a liquidity crisis could inflict on the FCS. These tools include exercising its enforcement powers under subtitle C of title V of the Act, and invoking its authority under § 615.5136 to increase the amount of liquid investments that FCS banks may hold in their liquidity reserve during an emergency.

The FCA now proposes to strengthen its supervisory and regulatory oversight of liquidity management at FCS banks. Under proposed § 615.5134(i), the FCA expressly reserves its right to require Farm Credit banks, either individually or jointly, to adjust their treatment of instruments (assets) in their liquidity reserves so they have liquidity that is sufficient and commensurate for the risks they face. This reservation of authority would enable the FCA to respond to adverse financial, economic, or market conditions by requiring any, some, or all Farm Credit bank(s) to take certain prescribed actions to protect FCS liquidity.

More specifically, the FCA reserves the authority under proposed § 615.5134(i) to require one or more FCS bank(s) to:

(1) Apply a greater discount to any individual security or any class of securities;

(2) Shift individual or multiple securities from one level of the liquidity reserve to another, or between one of the levels of the liquidity reserve and the supplemental liquidity buffer based on the performance of such asset(s), or based on financial, economic, or market conditions affecting the liquidity and solvency of the bank;

(3) Spread out or otherwise change concentrations in the allocation of securities in any level of the bank's liquidity reserve and its supplemental liquidity buffer;

(4) Perform additional stress tests using other or different stress criteria or scenarios;

(5) Hold additional liquid assets to cover unfunded commitments and other contingent outflows; or

(6) Take any other action that the Farm Credit Administration deems necessary to ensure that the bank has sufficient liquidity to meet its financial obligations as they fall due.

We invite your comments about any specific scenario that you think we should include in our reservation of authority. We also ask whether you think that there are other actions that the FCA could or should take during a significant stress event so it can act rapidly and decisively to staunch or prevent deterioration in the liquidity position of FCS banks on an individual or collective basis.

IV. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FCA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

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[1] See sections 1.3(a), 2.0(a), 2.10(a), 3.0, 4.25, and 8.1(a)(1) of the Act; 12 U.S.C. 2011(a), 2071(a), 2091(a), 2121, 2211, and 2279aa-1.

[2] See Pub. L. 101-73, sec. 1404(e)(1)(A), 103 Stat. 183, 552-53 (Aug. 9, 1989).

[3] Farm Credit banks (which are the four Farm Credit Banks and the Agricultural Credit Bank) issue and market System-wide debt securities through the Federal Farm Credit Banks Funding Corporation (Funding Corporation). The Funding Corporation, which is established pursuant to section 4.9 of the Act, is owned by all Farm Credit banks.

[4] The Federal Reserve Banks, the Federal Home Loan Banks, and National Credit Union Administration Central Liquidity Facility serve as a source of liquidity for commercial banks, savings associations, and credit unions both in ordinary times and during emergencies.

[5] Section 1101 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended section 13(3) of the Federal Reserve Act, 12 U.S.C. 343(3), to allow the Board of Governors the Federal Reserve System, in consultation with the Secretary of the Treasury, to establish by regulation, policies and procedures that would govern emergency lending under a program or facility for the purpose of providing liquidity to the financial system. Under section 13(3) of the Federal Reserve Act, as amended, the Board of Governors of the Federal Reserve System must establish procedures that prohibit insolvent and failing

entities from borrowing under the emergency program or facility. Pursuant to section 13(3) of the Federal Reserve Act, as amended, the Board of Governors of the Federal Reserve System, with the approval of the Secretary of Treasury could authorize the Federal Reserve Banks to serve as an emergency source of liquidity for the FCS, but it is not obligated to do so. See Pub. L. 11-203, title XI, sec. 1101(a), 124 Stat. 2113 (Jul. 21, 2010).

[6]If market access is completely impeded, the Farm Credit Insurance Fund would also be available to ensure the payments of maturing insured debt obligations. See 12 U.S.C. 2277a-9(c)(1).

[7]The FCA has broad authority under various provisions of the Act to supervise and regulate liquidity management at FCS banks. Section 5.17(a) of the Act authorizes the FCA to: (1) Approve the issuance of FCS debt securities under section 4.2(c) and (d) of the Act; (2) establish standards regarding loan security requirements at FCS institutions, and regulate the borrowing, repayment, and transfer of funds between System institutions; (3) prescribe rules and regulations necessary or appropriate for carrying out the Act; and (4) exercise its statutory enforcement powers for the purpose of ensuring the safety and soundness of System institutions.

[8]For example, financial institutions collectively had difficulty maintaining sufficient short-term liquidity in the aftermath of the attacks on September 11, 2001, and again in September and October of 2008 after several large financial institutions collapsed. During these crises, the Federal Reserve injected additional liquidity into the financial system in the United States.

[9]The five agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the now-defunct Office of Thrift Supervision.

[10]See 75 FR 13656 (Mar. 22, 2010)

[11]The FCA has periodically amended its liquidity regulations over the past 18 years. The FCA originally adopted § 615.5134 in 1993, and subsequently amended it 1999 and 2005. See 58 FR 63056 (Nov. 30, 1993); 64 FR 28896 (May 28, 1999); 70 FR 51590 (Aug. 31, 2005). Originally, § 615.5134 required each FCS bank to maintain 15 days of liquidity, and to separately identify investments held for the purpose of meeting its liquidity reserve requirement. In 1999, the FCA repealed the provision requiring FCS banks to separately identify investments held for liquidity. In 2005, the FCA expanded the liquidity reserve requirement to 90 days, increased the limit on investments from 30 to 35 percent of total outstanding loans, and for the first time, required all FCS banks to develop CFPs for liquidity.

[12]The FCA recently proposed substantive amendments to § 615.5133. The preamble to the proposed rule discusses the FCA's expectations concerning proper investment practices at FCS banks and associations. See 76 FR 51289 (Aug. 18, 2011). The FCA incorporates by reference its guidance about proper investment management practices in the preamble to § 615.5133 into this preamble.

[13]See Interagency Policy Statement on Funding and Liquidity Risk Management, supra at 13661.

[14]Id.

[15]Id.

[16]Id.

[17]Id at 13660.

[18]See 70 FR 51587 (Aug. 31, 2005); 58 FR 63039 (Nov, 30, 1993).

[19]See Interagency Policy Statement on Funding and Liquidity Risk, 75 FR 13656, 13661 (Mar. 22, 2010).

[20]See Pub. L. 111-203, sec. 939A, 124 Stat. 1376, 1887 (Jul. 21, 2010).

[21]See 76 FR 51289, 51298 (Aug. 18, 2011) and 76 FR 53344 (Aug. 26, 2011). The first cite is to the proposed rule on investment management. The FCA is soliciting comments on how to replace NRSRO credit ratings for eligible investments. The second cite is to an Advance Notice of Proposed Rulemaking concerning the NRSRO credit ratings in our capital regulations.

[22]Basel Committee on Banking Supervision, Basel III: International framework for liquidity risk measurement, standards, and monitoring, (Dec. 2010) p. 6.

[23]Id at p. 5.

[24]Id.

[25]Id.

[26]The proposed rule on investment management would change the designation of § 615.5131(e) by omitting the paragraph designations of all definitions in the regulation.

[27]" Existing § 615.5131(e) also states, "In the money market, a security is liquid if the spread between its bid and ask price is narrow and a reasonable amount can be sold at those prices."

[28]Duration measures the price sensitivity of a fixed income security to interest rate changes.

[29]See Basel III Liquidity Framework supra. at p. 5.

[30]Id.

[31]Id.

[32]Id.

[33]Id. Market breadth refers to the price impact per unit of liquidity, whereas market depth refers to units of the asset that can be traded for a given price impact.

[34]See Interagency Policy Statement on Funding and Liquidity Risk Management, supra. at 13660.

[35]Id.

[36]Id.

[37]Obligations that are backed by the full faith credit of the United States are not eligible for the liquidity reserve if they are not marketable under proposed § 615.5134(d).

[38]A Government-sponsored agency means as an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the United States Congress but whose obligations are not explicitly insured or guaranteed by the full faith and credit of the United States Government. The FCA proposed to add this definition to § 615.5132 on August 18, 2011. See 76 FR 51289 (Aug. 18, 2011). This category would include the Federal Home Loan Banks, Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), and the Tennessee Valley Authority. Although Fannie Mae and Freddie Mac are currently in conservatorship, their obligations are not explicitly backed by the full faith and credit of the United States.

[39]Once the Government-sponsored agency senior debt securities in Level 2 come within 60 days to maturity, the bank should move them to Level 1 of the liquidity reserve so they can cover maturing obligations.

[40]See Basel III Liquidity Framework supra. at p. 21-22. The Basel Committee on Banking Supervision focused on unfunded commitments throughout Basel III.

[41]See Interagency Policy Statement on Funding and Liquidity Risk Management, supra. at 13664.

[42]Id.

[43]Id. at 13665.

[44]Id.

[45]Id.

[46]Early warning signals and event triggers encompass events that are both global and bank specific. Examples of global warning signals and event triggers include: (1) Concerns over the credit quality of particular classes of assets widely held by financial institutions; (2) widening spreads between different types of securities, or derivatives; (3) macro-economic factors adversely affecting agriculture; and (4) debt market stagnation and constrictions. Warning signals and event triggers that are specific to individual FCS banks include: (1) Draws on unfunded commitments or letters of credit; (2) a rapid and substantial increase in loan demand; (3) actual and projected increases in collateral pledged; and (4) unrealized losses in its liquidity reserve. Events such as reduced market access and the downgrading of credit ratings could be either a global or bank-specific signal or trigger.

[47]See Interagency Policy Statement on Funding and Liquidity Risk Management, supra. at 13665.

List of Subjects in 12 CFR Part 615

Accounting, Agriculture, Banks, banking, Government securities, Investments, Rural areas.

For the reasons stated in the preamble, part 615 of chapter VI, title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 615--FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS, AND FUNDING OPERATIONS

1. The authority citation for part 615 is revised to read as follows:

Authority: Secs. 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.3, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b-6, 2279aa, 2279aa-3, 2279aa-4, 2279aa-6, 2279aa-7, 2279aa-8, 2279aa-10, 2279aa-12); sec. 301(a) of Pub. L. 100-233, 101 Stat. 1568, 1608; sec. 939A of Pub. L. 111-203, 124 Stat 1326, 1887.

2. Revise § 615.5134 to read as follows:

§ 615.5134 Liquidity reserve.

(a) *Liquidity policy.*

(1) *Board responsibility*. The board of each Farm Credit bank must adopt a written liquidity policy. The liquidity policy must be compatible with the investment management policies that the bank's board adopts pursuant to § 615.5133 of this part. At least once every year, the bank's board must review its liquidity policy, affirmatively validate the sufficiency of its liquidity policy, and make any revisions it deems necessary. The board of each Farm Credit bank must ensure that adequate internal controls are in place so that management complies with and carries out this liquidity policy.

(2) *Policy content*. At a minimum, the liquidity policy of each Farm Credit bank must address:

(i) The purpose and objectives of the liquidity reserve;

(ii) Diversification requirements for the liquidity reserve portfolio;

(iii) Maturity limits and credit quality standards for investments that the bank is holding to meet the minimum liquidity reserve requirements of paragraphs (b) and (e) of this section;

(iv) The target amount of days of liquidity that the bank needs based on its business model and risk profile;

(v) The Contingency Funding Plan (CFP) required by paragraph (h) of this section;

(vi) Delegations of authority pertaining to the liquidity reserve; and

(vii) Reporting requirements, which at a minimum must require management to report to the board at least once every quarter about compliance with the bank's liquidity policy and the performance of the liquidity reserve portfolio. Management must report any deviation from the bank's liquidity policy, or failure to meet the board's liquidity targets immediately to the board.

(b) *Liquidity reserve requirement*. Each Farm Credit bank must maintain a liquidity reserve, in accordance with paragraph (e) of this section, sufficient to fund at least 90 days of the principal portion of maturing obligations and other borrowings of the bank at all times. Each Farm Credit bank must also maintain a supplemental liquidity buffer in accordance with paragraph (f) of this section. Each Farm Credit bank must discount the liquid assets in its liquidity reserve and its supplemental liquidity buffer in accordance with paragraph (g) of this section. The liquidity reserve must be comprised only of cash, including cash due from traded but not yet settled debt, and qualified eligible investments under § 615.5140 of this part that are unencumbered and marketable under paragraphs (c) and (d) of this section, respectively.

(c) *Unencumbered*. All investments that a Farm Credit bank holds in its liquidity reserve in accordance with this section must be unencumbered. For the purpose of this section, an investment is unencumbered if it is free of lien, and it is not explicitly or implicitly pledged to secure, collateralize, or enhance the credit of any transaction. Additionally, an unencumbered investment held in the liquidity reserve cannot be used as a hedge against interest rate risk if liquidation of that particular investment would expose the bank to a material risk of loss.

(d) *Marketable*. All investments that a Farm Credit bank holds in its liquidity reserve in accordance with this section must be marketable. For the purposes of this section, an investment is marketable if it:

(1) Can be easily and immediately converted into cash with little or no loss in value;

(2) Exhibits low credit and market risks;

(3) Has ease and certainty of valuation; and

(4) Except for money market instruments, is listed on a developed and recognized exchange market, and can be sold or converted to cash through repurchase agreements in active and sizable markets.

(e) *Composition of liquidity reserve*. Each Farm Credit bank must continuously hold cash and the investments in the table below to meet the 90-day minimum liquidity reserve requirement in paragraph (b) of this section. A Farm Credit bank must apply the discounts in paragraph (g) of this section to all cash and investments in its liquidity reserve:

Level 1 Instruments: Each Farm Credit bank must sequentially apply Level 1 instruments to fund obligations that mature starting on day 1 through day 30. Cash and instruments with a final remaining maturity of 3 years or less must comprise at least 15 days of the liquidity reserve at Level 1.	· Cash; · Treasury securities; · Other marketable obligations that are explicitly backed by the full faith and credit of the United States; · Mortgage-backed securities issued by the Government National Mortgage Association; · Government-sponsored Agency senior debt securities that mature within 60 days, excluding senior debt securities of the Farm Credit System; and · Diversified investment Funds that are comprised exclusively of Level 1 instruments.
Level 2 Instruments: Each Farm Credit bank must sequentially apply Level 2 instruments to fund obligations that mature starting on day 31 through day 90.	· Additional amounts of Level 1 instruments; · Government-sponsored Agency senior debt securities with maturities that exceed 60 days, excluding senior debt securities of the Farm Credit System; · Government-sponsored Agency mortgage-backed securities; · Money market instruments maturing within 90 days; and · Diversified Investment Funds that are comprised exclusively of Levels 1 and 2 instruments.

(f) *Supplemental liquidity buffer*. Each Farm Credit bank must hold supplemental liquid assets in excess of the 90-day minimum liquidity reserve. The supplemental liquidity buffer must be comprised of cash and qualified eligible investments listed in § 615.5140 of this part. A Farm Credit bank must be able to liquidate any qualified eligible investment in its supplemental liquidity buffer within the liquidity policy timeframe established in the bank's liquidity policy at no less than 80 percent of its book value. A Farm Credit bank must remove from its supplemental liquidity buffer any investment that has, at any time, a market value that is less than 80 percent of its book value. The amount of supplemental liquidity that each Farm Credit bank holds, at minimum, must meet the requirements of its board's liquidity policy, provide excess liquidity beyond(5) the days covered by the liquidity reserve, and satisfy the applicable portions of the bank's CFP in accordance with paragraph (h) of this section.

(g) *Discounts*. Each Farm Credit bank must discount the liquid assets in its liquidity reserve under paragraph (d) of this section and in its supplemental liquidity buffer under paragraph (e) of this section as follows:

(1) Multiply cash and overnight investments by 100 percent.

(2) Multiply Treasury securities by 97 percent of the market value.

(3) Multiply all other Level 1 instruments by 95 percent of their market value, even if the bank holds them in Level 2 to fund obligations maturing starting on day 31 through day 90.

(4) Multiply all Level 2 instruments by 93 percent of the market value.

(5) Multiply all other qualified investments held for meeting the bank's liquidity policy and contingency plans by 85 percent of market value unless they merit Level 1 or Level 2 instrument discounts.

(h) *Contingency Funding Plan (CFP)*. The board of each Farm Credit bank must adopt a CFP to ensure sources of liquidity are sufficient to fund normal operations under a variety of stress events including market disruptions, rapid increase in loan demand, unexpected draws on unfunded commitments, difficulties in renewing or replacing funding with desired terms and structures, requirements to pledge collateral with counterparties, and reduced market access. Each Farm Credit bank must maintain an adequate level of unencumbered and marketable assets in its liquidity reserve that can be converted into cash to meet its net liquidity needs based on estimated cash inflows and outflows for a 30-day time horizon under an acute stress scenario. The board of directors must review and approve the CFP at least once every year and make adjustments to reflect changes in the bank's risk profile and market conditions. The CFP must:

(1) Be customized to the financial condition and liquidity risk profile of the bank and the board's liquidity risk tolerance policy.

(2) Identify funding alternatives that the Farm Credit bank can implement whenever access to funding is impeded, which must include, at a minimum, arrangements for pledging collateral to secure funding and possible initiatives to raise additional capital.

(3) Require periodic stress testing, which analyzes the possible impacts on the bank's cash inflows and outflows, liquidity position, profitability and solvency under a variety of stress scenarios.

(4) Establish a process for managing events that imperil the bank's liquidity, and assign appropriate personnel and implement executable action plans that carry out the CFP.

(i) *Reservation of Authority*. The Farm Credit Administration reserves the right to require a Farm Credit bank to adjust the treatment of assets in its liquidity reserve so that it has liquidity that is sufficient and commensurate for the risks it faces. The Farm Credit Administration reserves the right to use this authority in response to adverse financial, economic, or market conditions by requiring any Farm Credit bank, on a case-by-case basis, to:

(1) Apply a greater discount to any individual security or any class of securities;

(2) Shift individual or multiple securities from one level of the liquidity reserve to another, or between one of the levels of the liquidity reserve and the supplemental liquidity buffer based on the performance of such asset(s), or based on financial, economic, or market conditions affecting the liquidity and solvency of the bank;

(3) Spread out or otherwise change concentrations in the allocation of securities in any level of the bank's liquidity reserve and its supplemental liquidity buffer;

(4) Perform additional stress tests using other or different stress criteria or scenarios;

(5) Hold additional liquid assets to cover unfunded commitments and other contingent outflows; or

(6) Take any other action that the Farm Credit Administration deems necessary to ensure that the bank has sufficient liquidity to meet its financial obligations as they fall due.

Date: December 15, 2011

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.

76 FR 51289, 08/18/2011

Handbook Mailing HM-11-9

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AC50

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Investment Management

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, Agency, us, our, or we) proposes to amend our regulations governing investments held by institutions of the Farm Credit System (FCS or System). We propose to strengthen our regulations governing investment management, interest rate risk management, and association investments; revise the list of eligible investments to ensure it is limited only to high-quality, liquid investments; reduce regulatory burden for investments that fail to meet eligibility criteria after purchase or are unsuitable; and make other changes that will enhance the safety and soundness of System institutions. In this proposal, we also seek comments on compliance with section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or DFA), which requires us to remove all references to and requirements relating to credit ratings and to substitute other appropriate standards of creditworthiness. We also seek comment on other issues.

DATES: You may send us comments by November 16, 2011.

ADDRESSES: We offer a variety of methods for you to submit comments on this proposed rule. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the Agency's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration,

1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Timothy T. Nerdahl, Senior Financial Analyst, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (952) 854-7151 extension 5035, TTY (952) 854-2239;

or

Jennifer A. Cohn, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of this proposed rule are to:

- Ensure that Farm Credit banks[1] hold sufficient high-quality, readily marketable investments to provide sufficient liquidity to continue operations and pay maturing obligations in the event of market disruption;
- Strengthen the safety and soundness of System institutions;
- Discuss the requirements of section 939A of the Dodd-Frank Act;
- Reduce regulatory burden with respect to investments that fail to meet eligibility criteria after purchase or are unsuitable; and
- Enhance the ability of the System to supply credit to agriculture and aquatic producers by ensuring adequate availability to funds.

II. Background

Congress created the System as a Government-sponsored enterprise (GSE) to provide a permanent, stable, and reliable source of credit and related services to American agriculture and aquatic producers. Farm Credit banks obtain funds used by System banks and associations to provide credit and related services primarily through the issuance of System-wide debt securities.[2] If access to the debt market becomes temporarily impeded, Farm Credit banks must have enough readily available funds to continue operations and pay maturing obligations.

Subpart E of part 615 imposes comprehensive requirements regarding the investments of System institutions (primarily Farm Credit banks).[3] Section 615.5134(a) of FCA regulations requires each Farm

Credit bank to maintain a specified liquidity reserve.[4] This liquidity reserve may only be funded from cash and eligible investments.[5]

We adopted our last major revisions to our investment regulations in 1999 and amended them in a more limited manner in 2005. Since 1999, the marketplace pertaining to investments has changed significantly. Innovations in investment products have led to their increasing complexity, and investors need to have greater expertise to fully understand them. In addition, the financial crisis that began in 2007 resulted in numerous investment downgrades and the loss of billions of dollars by financial institutions.

While System banks suffered considerably less stress during the crisis than many other financial institutions, they did experience numerous downgrades and some losses on individual investments. In 2010, we issued a bookletter that provides clarification and guidance regarding our regulations and expectations with respect to the key elements of a robust investment asset management framework that institutions should establish to prudently manage their investments in changing markets.[6] The issuance of this bookletter was an interim measure towards strengthening our investment regulations.

In July 2010, the President signed into law the Dodd-Frank Act to strengthen regulation of the financial industry in the wake of the financial crisis that unfolded in 2007 and 2008. As discussed in greater detail below, section 939A of the DFA requires each Federal agency to revise all of its regulations that refer to or require reliance on credit ratings to assess creditworthiness of an instrument to remove the reference or requirement and to substitute other appropriate creditworthiness standards.

We now propose amendments that would strengthen our investment regulations. In addition, in certain areas, including compliance with section 939A of the DFA, we seek comments but propose no specific regulatory revisions. In these areas, we will likely have to propose revisions before we will be able to adopt revisions as final. We will consider all comments received in this or future rulemakings, as appropriate.

III. Section-by-Section Description of the Proposed Rule

Following is a section-by-section description of the proposed revisions to our rules.

A. Section 615.5131 – Definitions

We propose to amend § 615.5131 to add two new definitions to reflect clarifications we propose to make to § 615.5140, as discussed below. We propose adding a definition for Government agency, which we would define as the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations are fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States Government. We also propose adding a definition for Government-sponsored agency. We would define this term as an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the United States Congress but whose obligations are not explicitly insured or guaranteed by the full faith and credit of the United States Government. This definition would include GSEs such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), as well as Federal agencies, such as the Tennessee Valley Authority, that issue obligations that are not explicitly guaranteed by the Government of the United States' full faith and credit.

B. Section 615.5132 – Investment Purposes

In 2005, we modified § 615.5132 to increase the permissible level of investments that Farm Credit banks may hold from 30 to 35 percent of total outstanding loans. The reason for the increase was to provide the banks with additional flexibility to meet their liquidity needs and accomplish their asset/liability management strategies in varying economic conditions. At this time, we continue to believe that the investment maximum of 35 percent of total outstanding loans provides the banks adequate flexibility to maintain their liquidity reserve at an appropriate amount. However, as discussed below, we solicit public comments on this issue.

In this discussion, we emphasize the proper application of a provision of this regulation. We also discuss a proposed revision and an area where we specifically seek the views of commenters.

1. Permissible Investment Purposes

Section 615.5132 permits each Farm Credit bank to hold eligible investments for the purposes of maintaining a liquidity reserve, managing surplus short-term funds, and managing interest rate risk. These purposes do not authorize Farm Credit banks to accumulate investment portfolios for arbitrage activities or to engage in trading for speculative or primarily capital gains purposes.[7] Realizing gains on sales before investments mature is not a regulatory violation as long as the profits are incidental to the specified permissible investment purposes. Farm Credit banks must ensure that their internal controls, required under §§ 615.5133(e) and 618.8430, ensure that eligible investments listed in § 615.5140(a) are limited to those that are appropriate under § 615.5132.

2. Excluding Investments Pledged to Meet Margin Requirements for Derivative Transactions

Section 615.5132 permits Farm Credit banks to hold eligible investments, for specified purposes, in an amount not to exceed 35 percent of its total outstanding loans. We propose to permit banks to exclude investments pledged to meet margin requirements for derivative transactions (collateral) when calculating the 35-percent investment limit. We note that investments that are pledged as collateral do not count toward a Farm Credit bank's compliance with its liquidity reserve requirement.[8] Derivatives are used as a hedging tool against interest rate risk and liquidity risk. Farm Credit banks use derivative products as an integral part of their interest rate risk management activities and as a supplement to the issuance of debt securities in the capital markets. We recognize that banks are required to post collateral to counterparties resulting from entering into derivative transactions, and we believe banks should not be discouraged from implementing appropriate risk management practices.

3. Treasury Securities and the 35-Percent Investment Limit

Historically, Farm Credit banks have invested in instruments that generate yield in excess of the cost of funds (positive carry). Since the recent financial crisis, however, the banks have experienced decreased liquidity with these instruments at times, and they have turned to United States Treasury securities because of their high liquidity.[9] Treasury securities generally have yields that are lower than the cost of the underlying Farm Credit debt that would fund such securities, and this negative carry has an adverse impact on bank earnings.

Under our existing 35-percent investment limit, holding Treasury securities reduces the maximum amount of investments that Farm Credit banks may hold in other eligible securities. Thus, the banks must choose between greater liquidity but a negative carry, or a positive carry but reduced liquidity.[10] Banks would be able to avoid making this choice if they were permitted to exclude a portion of or all Treasuries or to apply a discount to Treasury securities when calculating the 35-percent limit.

We currently believe that the 35-percent limit continues to provide sufficient flexibility for Farm Credit banks to maintain adequate liquidity. However, we have received a request from a System workgroup asking us to consider treating Treasury securities as cash for purposes of this provision.

Consequently, we seek comment on whether and how to address the situation Farm Credit banks face in holding Treasury securities. Are Farm Credit banks able to purchase sufficient Treasury securities to enhance liquidity, while remaining within the constraint that total investments may not exceed 35 percent of total outstanding loans? Or should the percentage be raised and, if so, to what level and why? Should Treasuries be excluded from total investments when calculating the percentage of total investments to total loans outstanding? Would it be appropriate to exclude a portion of Treasury securities from the calculation? Would it be appropriate to apply a discount to Treasuries? What would be the basis for such a calculation change?

C. Section 615.5133 – Investment Management

Effective investment management requires financial institutions to establish policies that include risk limits, approved mechanisms for identifying, measuring, and reporting exposures, and strong corporate governance. The recent crisis and its lingering effects have re-emphasized the importance of sound investment management, and we believe that strengthened regulation would further ensure the safe and sound management of investments. Accordingly, we are proposing significant changes to § 615.5133, which governs investment management.[11]

In addition, we propose minor technical, clarifying, and non-substantive language changes to this section that we do not specifically discuss in this preamble.

1. Proposed § 615.5133(a) – Responsibilities of Board of Directors

We propose enhancements to the responsibilities of each board of directors set forth in § 615.5133(a). The existing regulation requires the board to review its investment policies annually and to make any changes that are needed. We believe that depending on the situation, this review may need to occur more than once a year. We would continue to require a review at least annually but, to reduce unnecessary regulatory burden, we propose to permit a designated board committee to conduct this review and to validate the sufficiency of the investment policies, provided that the board must adopt any changes to the policies.

2. Proposed § 615.5133(b) – Investment Policies – General Requirements

Section 615.5133(b) lists the items that a board's investment policy must address, but it currently does not include every requirement of § 615.5133. For example, existing § 615.5133(e) requires an institution to establish internal controls, and existing § 615.5133(f) requires specified securities valuation, but existing § 615.5133(b) does not require these items to be addressed in the investment policy. Our proposal would require that the investment policy address every requirement of § 615.5133. This revision would clarify our expectations as to the appropriate content of the board's policies.

We would also require that investment policies must address the means for reporting, and approvals needed for, exceptions to established policies. Because the investment policies are established by the board, we believe it is important for the board's policies to address how exceptions to those policies will be handled. We believe exceptions to a policy should be rare, because frequent exceptions call into question the adequacy of the policy.

In addition, we propose that institutions must document in their records or board minutes any analyses used in formulating policies or amendments to the policies. An accurate record of the analysis used to formulate investment policies documents appropriate governance. It also provides a trail for future directors and managers to review to fully understand how previous boards of directors arrived at their decisions and why they approved the policy in the form they did.

3. Proposed § 615.5133(c) – Investment Policies – Risk Tolerance

Our proposed changes are intended to make the investment policies' risk tolerance discussion more robust. In addition to the existing requirements of this section, investment policies would have to establish concentration limits for the various types and sectors of eligible investments and for the entire investment portfolio. We propose to delete the requirement that investment policies must establish diversification requirements, because the new concentration limit requirement would necessarily lead to diversification.

a. Proposed § 615.5133(c)(1) – Credit Risk

Existing § 615.5133(c)(1)(i) provides that investment policies must establish credit quality standards, limits on counterparty risk, and risk diversification standards that limit concentrations based on a single or related counterparty(ies), a geographical area, industries, or obligations with similar characteristics. We propose to clarify that concentration limits be based on either a single or related counterparty(ies). Further, concentration limits must also be based on a geographical area, industries or sectors, asset classes, or obligations with similar characteristics. We believe this amendment would ensure that diversification is more thoroughly considered by System institutions.

Existing § 615.5133(c)(1)(ii) requires investment policies to establish criteria for selecting securities firms. It requires the board annually to review the criteria for selecting securities firms and determine whether to continue existing relationships. To reduce unnecessary regulatory burden, we propose to permit a designated committee of the board to review the criteria and to determine whether to continue existing relationships, but the board must approve any changes to the criteria and any changes to the existing relationships. This change would permit a designated committee to use its technical expertise to assist the board in carrying out its responsibilities.

Existing § 615.5133(c)(1)(iii) requires investment policies to establish collateral margin requirements on repurchase agreements. We propose to require institutions to regularly mark the collateral to market and ensure appropriate controls are maintained over collateral held. We believe it is prudent for institutions to manage potential counterparty risk and to establish appropriate counterparty margin requirements based on the quality of the collateral and the terms of the agreement.

b. Proposed § 615.5133(c)(2) – Market Risk

We propose changes to § 615.5133(c)(2), which relates to market risk. Specifically, we propose to link this regulation to our stress-testing requirements contained in proposed § 615.5133(f)(2), our interest rate risk requirements contained in § 615.5135, and other policies and guidance. These changes clarify our expectations that the board consider all aspects of market risk.

4. Proposed § 615.5133(e) – Internal Controls

We propose to modify our internal controls requirements in § 615.5133(e). In § 615.5133(e)(2), we propose adding additional personnel to the list of personnel whose duties and supervision should be separated from personnel who execute investment transactions. These additional personnel are those who post accounting entries, reconcile trade confirmations, and report compliance with investment policy. We believe this additional separation is a best practice that System institutions should have in place to ensure controls are sufficient and appropriate.

We also propose a new § 615.5133(e)(4). This provision would require each institution to implement an effective internal audit program to review, at least annually, investment controls, processes, and compliance with FCA regulations and other regulatory guidance. The internal audit program would specifically have to include a review of the processes used for ensuring all investments, at the time of purchase, are eligible and suitable for purchase under the board's investment policies and for ensuring investments continue to meet all applicable generally accepted accounting principles even if they are no longer part of the liquidity portfolio.

Existing § 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. Our regulations do not, however, discuss the internal audit of the investment function specifically. However, FCA Bookletter BL-064 provides guidance on FCA expectations in this area. We now propose to strengthen this guidance by adding it as a regulatory requirement in § 615.5133(e)(4).

As we stated in FCA Bookletter BL-064, under § 618.8430 an institution's board is responsible for ensuring that sound systems and controls are in place to manage investment risks. Senior management is responsible for implementing an effective control environment to manage risk in an institution's investment portfolio, as well as to ensure compliance with applicable laws and regulations. Internal audit is a critical function that ensures appropriate internal controls are in place. Accordingly, our proposal would require System institutions to establish internal controls to ensure that an independent review over investment practices and controls, including specifically the process for determining eligibility and suitability, is conducted.

An institution's audit plan must include a risk assessment, at least annually, of the investment function by the internal audit department or by an outside vendor if the expertise in-house does not exist. Moreover, an institution must conduct an internal audit of the investment function at least annually. As we stated in FCA Bookletter BL-064, the frequency and scope of review should be based on the complexity and size of the investment portfolio. 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.

5. Proposed § 615.5133(f) – Due Diligence to Determine Eligibility, Suitability, and Value of Investments

We propose to add a new § 615.5133(f). This provision would cover the due diligence institutions must perform to determine eligibility, suitability, and value of investments. This provision would combine in one location the requirements governing securities valuation and those governing stress testing that are now in existing § 615.5133(f) and § 615.5141, respectively. Our proposed revisions would make these requirements more robust and less burdensome.

a. Proposed § 615.5133(f)(1) - Eligibility and Suitability for Purchase

In new § 615.5133(f)(1), we propose that before an institution purchases an investment, it must conduct sufficient due diligence to determine whether the investment is eligible under § 615.5140 and suitable for purchase under the investment policies of the institution's board. We propose to retain from existing § 615.5133(f)(1) the requirement that the institution must verify the value of the investment (unless it is a new issue) with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction. We also propose to require that an institution's investment policies must fully address the extent of pre-purchase analysis that management must perform for various classes of investments and that the institution must document its assessment of eligibility and suitability, including the information used in its assessment. The provision would permit the institution to use all available sources, including third party sources, to assess the investment. Finally, the provision would require that the institution's assessment of each investment at the time of purchase must at a minimum include an evaluation of credit risk, liquidity risk, market risk, and interest rate risk, and an assessment of the cash flows and the underlying collateral of the investment.

This proposed regulation builds on our expectations for institutions to conduct proper due diligence, which we conveyed in FCA Bookletter BL-064. 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. FCA expects that institutions must 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. In general, institutions should conduct and document due diligence analyses separately for each investment security. Modeling cash flows and assumptions at the time of purchase provides insight into the changing risks certain investments present.

We believe that documentation of the analysis conducted is a critical component for assessing and verifying eligibility and suitability. Investment policies must require that an adequate level of analysis be conducted on the various classes of investments purchased. Under this proposed regulation, System institutions that engage in investment activity will need to strengthen their due diligence process and improve their documentation as to why the investment was purchased.

We expect that institutions will evaluate each investment they purchase using various sources available to them, including third parties if warranted, to assess whether an investment meets the eligibility requirements. Institutions may not, however, rely exclusively on third parties to justify the purchase of a security. Institutions must always conduct their own due diligence, because management and the board are ultimately responsible for any decisions. Moreover, because of the particular concerns surrounding the accuracy of credit ratings, institutions must be especially cautious if they choose to consider them.

b. <u>Proposed § 615.5133(f)(2) – Pre-Purchase and Quarterly Stress Testing</u>

We propose moving our investment stress-testing requirements into § 615.5133(f)(2), as part of our due diligence and security valuation requirements, and removing existing § 615.5141 as a stand-alone, stress-testing regulation. We propose this change because stress-testing is a key component of due diligence. It is used to assess the risk presented by an investment and the changes in valuation that may be experienced from movements in interest rates. In addition, we propose changes to the substance of the stress-testing requirements.

Existing § 615.5141 requires pre-purchase and quarterly interest rate stress testing for mortgage securities. It provides that mortgage securities are not eligible investments unless they pass a stress test, and it requires divestiture of a mortgage security that no longer complies with the stress-testing requirements.

In the preamble to the 1999 final rule, in which we adopted the existing stress-testing requirements, we stated that we believed stress-testing was an essential risk management practice because even highly rated mortgage securities may expose investors to significant interest rate risk.[12] We therefore stated that "each System institution needs to employ appropriate analytical techniques and methodologies to measure and evaluate interest rate risk inherent in mortgage securities. More specifically, prudent risk management practices require every System institution to examine the performance of each mortgage security under a wide array of possible interest rate scenarios."[13]

Because of the importance of stress testing and the increasing complexity of investments, we propose in a new § 615.5133(f)(2) that all investments -– not just mortgage securities, and including Treasury securities -- must be stress tested before purchase and on a quarterly basis. This new requirement would enable System institutions to gain insight into the price movements of all securities they purchase. We understand that stress-testing for investments that have indexed rates that reprice at intervals of 12 months or less or have extremely short terms (such as Fed Funds and certain commercial paper) may be viewed as unnecessary. However, we believe that all investments must be stress tested to build a robust stress-testing environment that provides for a comprehensive and consistent analytical framework from which to evaluate the risks in the investment portfolio. It is also an important part of due diligence and the ongoing evaluation process.

Existing § 615.5141 provides two stress-testing options. In the first option, we set forth a standardized, three-pronged stress test that includes an average life test, an average life sensitivity test, and a price sensitivity test. In the second prong, we permit institutions to use alternative stress-test criteria and methodologies to evaluate the price sensitivity of mortgage securities.

We now propose to eliminate the standardized stress test. Since we first allowed the alternative stress test, we believe that every Farm Credit bank that invests in mortgage securities has moved to the alternative test and that none continue to use the standardized test. We discuss new stress-testing requirements, set forth in § 615.5133(f)(2)(iii), below.

To reduce regulatory burden, we propose in new § 615.5133(f)(2)(i) that an institution may purchase, with board approval, an investment that exceeds the stress-test parameters defined in its board's policies. We believe this flexibility is necessary because the financial markets continue to be very dynamic and a particular investment may not meet a board's parameters but may nevertheless provide additional liquidity or interest risk protection.

We propose in new § 615.5133(f)(2)(ii) that at the end of each quarter, each institution must stress test its entire investment portfolio, including a stress test of each individual investment, in accordance with paragraph (f)(2)(iii), as defined in its board policy. An investment that exceeds the board-defined stress parameters would not become ineligible and would not need to be divested. Rather, the board policy defining the stress tests would have to specify what actions the institution would take if its portfolio (but not an individual investment) exceeded the quarter-end, stress-test parameters defined in the policy, including the development of a plan to bring the portfolio back into compliance with those parameters.

We believe that stress testing the entire investment portfolio at each quarter-end will provide significant insight into the risks associated with the investment portfolio. We also believe that requiring the stress testing of individual investments on a quarterly basis is just a component of understanding how each individual investment affects the entire portfolio. Should an institution's entire portfolio exceed its board's stress-testing policy parameters it would have to develop a plan to bring the portfolio back into compliance. This plan should specify how the institution would bring the portfolio back into compliance and what timeframes are involved.

As discussed below, in § 615.5133(g)(2) we propose to require an institution to provide immediate notification to the board or a designated board committee if its stress test for the entire portfolio exceeds its board's policy parameters. We believe that a portfolio stress test that exceeds board parameters discloses a serious situation that could threaten the safety and soundness of the institution and that directors should be notified and a plan developed to reduce portfolio risk.

Proposed § 615.5133(f)(2)(iii) sets forth the requirements for pre-purchase and quarter-end stress tests. These requirements are for the most part unchanged from our existing requirements in § 615.5141 governing the alternative stress test. We discuss the differences below.

Proposed § 615.5133(f)(2)(iii) would require that the pre-purchase and quarter-end stress tests be defined in a board approved policy and include defined parameters for the types of securities an institution purchases. The stress tests would have to be comprehensive and appropriate for the risk profile of the institution. At a minimum, the stress tests would have to be able to measure the price sensitivity of investments over different interest rate/yield curve scenarios. The methodology that the institution uses to analyze investment securities would have to be appropriate for the complexity, structure, and cash flows of the investments in its portfolio.

The stress tests would have to enable the institution to determine at the time of purchase and each subsequent quarter-end that its investment securities, either individually or on a portfolio-wide basis, do not expose its capital, earnings, or liquidity to excessive risks. Also, the stress tests would have to enable the institution to evaluate the overall risk in the investment portfolio and compare it with defined board policy limits.

Two of the new requirements in this proposal -— the requirement that all securities, not just mortgage securities, must be stress tested; and the requirement that securities must be stress tested on a portfolio-wide basis —- are discussed above. The other new requirement is that stress tests would have to enable an institution to determine that its investment securities do not expose it to excessive liquidity risk. We propose this requirement because we believe an institution should have insight into the amount of cash it could obtain through the sale of investments, if necessary.

In conducting its stress tests, an institution would have to rely, to the maximum extent practicable, on verifiable information to support all of its assumptions, including prepayment and interest rate volatility assumptions, when applying its stress tests. An institution would have to document the basis for all assumptions used to evaluate a security and its underlying collateral, and it would also have to document all subsequent changes in its assumptions.

In this proposal, we specifically seek comment on several areas related to stress testing. Should FCA retain a standardized stress-testing option for institutions that do not wish to or do not have the capability of defining their own stress tests? Given that the Dodd-Frank Act requires us to eliminate credit ratings as a criterion for the eligibility of investments, would allowing System institutions to develop their own standards result in a variety of investment portfolios that exhibit substantially different risk profiles? Could this result in an inappropriate amount of risk in some investment portfolios? Also, should our regulations require stress-testing on all investments at the time of purchase? If not, on which investments should we require stress-testing, and why? Should institutions be required to stress test their individual investments and their entire investment portfolio on a quarterly basis? Why or why not?

c. **Proposed § 615.5133(f)(3) – Ongoing Value Determination**

We propose to redesignate existing § 615.5133(f)(2) as § 615.5133(f)(3). We propose to revise the last sentence of this provision to require an institution to evaluate the credit quality and price sensitivity of each investment in its portfolio and of its whole investment portfolio to the change in market interest rates. This change would clarify the meaning of this provision. We also propose to make other non-substantive changes to this provision.

d. **Proposed § 615.5133(f)(4) – Presale Value Verification**

We propose to redesignate existing § 615.5133(f)(3) as § 615.5133(f)(4) and to change the word "security" to "investment."

6. **Proposed § 615.5133(g) – Reports to the Board of Directors**

We propose revisions to § 615.5133(g), which specifies information that management must report to the board or a board committee each quarter. Proposed § 615.5133(g)(1) would retain the general quarterly reporting requirements but would add to and modify them to strengthen the overall reporting requirements. Proposed § 615.5133(g)(2) would add a special reporting requirement.

Proposed § 615.5133(g)(1) would require management to report to the board of directors or a designated board committee at least quarterly on the following:

- Plans and strategies for achieving the board's objectives for the investment portfolio;
- Whether the investment portfolio effectively achieves the board's objectives;
- The current composition, quality, and liquidity profile of the investment portfolio;
- The performance of each class of investments and the entire investment portfolio, including all gains and losses that the institution incurred during the quarter on individual investments that it sold before maturity and why they were liquidated;
- Potential risk exposure to changes in market interest rates as identified through quarterly stress testing and any other factors that may affect the value of the institution's investment holdings;
- How investments affect the institution's capital, earnings, and overall financial condition;
- Any deviations from the board's policies (must be specifically identified); and
- The results of the institution's quarterly stress test.

We believe that these reporting requirements are best practices and are items that boards of directors or a designated board committee must know to exercise proper governance. We also believe that the use of the investment plan discussed below would be an important tool and an effective way to report to the board on the requirements above. Presenting an investment plan and its results to the board or designated board committee would provide assurances that all required reporting takes place.

Proposed § 615.5133(g)(2) would add a special reporting requirement. It would require an institution to provide immediate notification to its board of directors or to a designated board committee if its portfolio exceeded the quarterly stress-test parameters defined in the board policy required by proposed § 615.5133(f)(2)(ii). We propose this requirement because exceeding board policy parameters could lead to serious risk exposures for the institution.

7. Investment Plan and Investment Oversight Committee

Although not a regulatory requirement, each System institution that maintains an investment portfolio should develop an investment plan and establish a formal investment oversight committee. These practices enable management to implement the investment direction provided by the institution's board. In addition, as discussed above under reporting, management's presentation of an investment plan to the board or designated board committee, along with the investment portfolio results, would provide assurances that required reporting takes place.

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 an appropriate management committee. The investment plan should help provide for effective guidelines and control over the investment portfolio. The plan should be a working document that can deal with changes in market conditions.
Investment plans should describe:

- The target portfolio composition given the board's investment policy, current market conditions, and projected liquidity needs;
- The rebalancing activities needed to achieve the target portfolio; and
- The performance measures that will be used to measure portfolio performance. Such measures should include 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 to serve as an additional control over investment management. In the past, the asset/liability management committees, which oversee the management of investment portfolios in most System institutions, have generally provided sufficient oversight of these portfolios. However, the importance, volume, and growing complexity of System investments may warrant additional expertise in the form of a more specialized investment committee. 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 could also provide appropriate monitoring and governance as well as provide structure or formalization of many of the informal processes.

D. Section 615.5135 – Management of Interest Rate Risk

Interest rate risk management is an important part of the overall financial management of a Farm Credit bank. The potentially adverse effects that interest rate risk may have on net interest income and the market value of equity is of particular importance.

We believe that strong policy direction from a Farm Credit bank's board of directors is essential to an effective interest rate risk management program. Existing § 615.5135 requires a bank's board to adopt an interest rate risk management section of an asset/liability management policy. Our proposed revisions to this rule would strengthen a bank's interest rate risk management program. The existing requirements would remain. In addition, the revisions would require the interest rate risk management section of the asset/liability management policy to establish policies and procedures for the bank to:

- Address the purpose and objectives of interest rate risk management;
- Consider the impact of investments on interest rate risk based on the results of the stress testing required under proposed § 615.5133(f)(2)[14];
- Describe actions needed to obtain its desired risk management objectives;
- Identify exception parameters and approvals needed for any exceptions to the requirements of the board's policies;
- Describe delegations of authority;
- Describe reporting requirements, including exceptions to limits contained in the board's policies; and
- Consider the nature and purpose of derivative contracts and establish counterparty risk thresholds and limits for derivatives used to manage interest rate risk.

Boards of directors set policy direction for the institution. Bank management carries out this direction and is responsible for reporting back to the board on its implementation of board direction and results. Consequently, we would expect that many of the above requirements would be carried out by management or a committee comprised of management and directors.

In addition, our proposal would require that management of each Farm Credit bank must report at least quarterly to its board of directors, or to a designated committee of the board, describing the nature and level of interest rate risk exposure. Any deviations from the board's policy on interest rate risk must be specifically identified in the report and approved by the board or a designated committee of the board.

Finally, we propose several minor technical and clarifying amendments, such as changing "shall" to "must".

E. <u>Section 615.5136 – Emergencies Impeding Normal Access of Farm Credit Banks to Capital Markets</u>

This section provides that an emergency shall be deemed to exist whenever a financial, economic, agricultural, or national defense crisis could impede the normal access of Farm Credit banks to the capital markets. Whenever FCA determines, after consultations with the Funding Corporation, that such an emergency exists, the FCA Board shall, in its sole discretion, adopt a resolution that increases the amount of eligible investments that banks are authorized to hold pursuant to § 615.5132, and/or modifies or waives the liquidity reserve requirement in § 615.5134.

We propose revisions to provide additional flexibility to the resolution that the FCA Board may adopt. First, in recognition that events such as the 2008 market turmoil may not allow for the deliberation contemplated by this regulation, we propose to clarify that the Funding Corporation consultation should occur only "to the extent practicable." Second, the proposed rule would provide that FCA "may", rather than "shall", adopt a resolution. Third, rather than permitting the resolution to increase the authorized amount of eligible investments, the proposed rule would permit the resolution to modify the amount, qualities, and types of authorized, eligible investments. Finally, we propose to expressly permit the resolution to authorize other actions as deemed appropriate.

F. Section 615.5140 – Eligible Investments

We last revised our listing of eligible investments, at § 615.5140, in 1999.[15] Those amendments expanded the list of eligible investments and relaxed or repealed certain restrictions that had previously been in the regulation. As a result, those amendments allowed System institutions to purchase and hold a broader array of high-quality and liquid investments. Those revisions reflected changes in the financial markets and helped fulfill our objective of developing a regulatory framework that could more readily accommodate innovations in financial products and analytical tools.

The recent financial crisis resulted in substantial turmoil in the financial markets. Overall, System institutions weathered this crisis better than many other regulated financial institutions. We believe this is due in part to the limited scope of authorized investments. Even so, some System institutions did experience losses on certain types of investments.

Based on this experience, we now propose amendments that would clarify which investments are eligible, eliminate certain investments, and reduce portfolio limits where appropriate. In addition, we ask questions about the most effective way to comply with section 939A of the DFA. As discussed in greater detail below, that provision requires each Federal agency to revise all regulations that refer to or require reliance on credit ratings to assess creditworthiness of an instrument to remove the reference or requirement and to substitute other appropriate creditworthiness standards.

1. Proposed Revisions to § 615.5140(a)

a. Proposed § 615.5140(a) – Introductory Paragraph

We propose revisions to the language in the introductory paragraph of § 615.5140(a). The existing language authorizes institutions to hold only the eligible investments that are listed and prohibits institutions from purchasing investments that are not listed. It also prohibits them from holding investments that were eligible when purchased but that subsequently became ineligible.

Like our existing regulation, our proposal would permit institutions to purchase only those investments that satisfy the eligibility criteria in § 615.5140. An investment that does not satisfy the eligibility criteria would not be eligible for purchase and would be subject to the divestiture requirements of proposed § 615.5143(a) if it were purchased.[16]

In a change from our existing approach, however, eligibility would be determined only at the time of purchase. An investment that satisfies the eligibility criteria at the time of purchase but that subsequently failed to satisfy the eligibility criteria would not become ineligible and would not have to be divested. Instead, it would be subject to the requirements of proposed § 615.5143(b), which would permit an institution to retain the investment subject to certain conditions.[17] As discussed below, in our discussion of our proposed amendments to § 615.5143, we believe this change would reduce regulatory burden without creating safety and soundness concerns.

In addition, existing § 615.5140(a) states that all investments must be denominated in United States dollars. We propose to relocate this language to § 615.5140(b).

b. Proposed § 615.5140(a)(1) and (a)(2) – Obligations of the United States and Obligations of Government-Sponsored Agencies

Existing § 615.5140(a)(1) lists "Obligations of the United States" as an eligible asset class. Under that heading three items are listed: Treasuries; agency securities (except mortgage securities); and other obligations fully insured or guaranteed by the United States, its agencies, instrumentalities, and corporations. We believe this listing is confusing and does not appropriately differentiate among obligors. Although the heading reads "Obligations of the United States," the second and third items are intended to include debt securities and other non-mortgage obligations of GSEs such as Fannie Mae and Freddie Mac, which are not obligations of the United States.[18]

Accordingly, we propose to split this listing into two categories. We do not intend any substantive changes with this proposed revision. We intend only to clarify the existing language.

The first listing, under § 615.5140(a)(1), would be headed "Obligations of the United States," and it would include only non-mortgage obligations, including but not limited to Treasuries, that are fully insured or guaranteed by a Government agency (which by definition means they are backed by the full faith and credit of the United States).[19] The second listing, under § 615.5140(a)(2), would be headed "Obligations of Government-Sponsored Agencies," and it would include debt securities and other non-mortgage obligations of GSEs, as well as of Federal agencies, such as the Tennessee Valley Authority, that issue obligations that are not explicitly insured or guaranteed by the full faith and credit of the United States.[20]

Proposed § 615.5140(a)(2) would permit institutions to purchase obligations of Government-sponsored agencies only if the obligations are senior debt securities. We believe that limiting permissible investments in this manner helps to ensure that institutions maintain only the highest quality investments in their portfolios.

c. Proposed § 615.5140(a)(3) – Municipal Securities

Existing § 615.5140(a)(2) places no investment portfolio limits for general obligation municipal securities. We propose to modify this provision (redesignated as § 615.5140(a)(3)) to impose a 15-percent investment portfolio limit on these securities. We propose this limit because we believe that a portfolio solely comprised of general obligation municipal securities would not provide sufficient liquidity in the event of a crisis in that particular market. We note that this limit is consistent with our existing revenue bond municipal securities investment portfolio limit.

d. Proposed § 615.5140(a)(4) – International and Multilateral Development Bank Obligations

Existing § 615.5140(a)(3) places no final maturity limit and no investment portfolio limit on international and multilateral development bank obligations. In redesignated § 615.5140(a)(4), we propose imposing a 10-year maturity limit and a 15-percent investment portfolio limit, to ensure a more diversified and liquid portfolio. We believe that a portfolio containing longer term obligations or comprised of an excess of these obligations would not provide sufficient liquidity in the event of a crisis in that particular market. We note that System institutions have invested in these obligations only on a limited basis.

e. Proposed § 615.5140(a)(5) – Money Market Instruments

Existing § 615.5140(a)(4) permits institutions to invest in repurchase agreements that satisfy specified conditions. If the counterparty defaults, the regulation requires the institution to divest non-eligible securities in accordance with the divestiture requirements of § 615.5143. Under our proposal, (redesignated § 615.5140(a)(5)) as discussed above, an eligible investment could not become ineligible, and would not be required to be divested. Accordingly, we propose to delete this divestiture requirement.

f. <u>Proposed § 615.5140(a)(6) – Mortgage Securities</u>

Existing § 615.5140(5) requires stress testing of all mortgage securities. As discussed above, proposed § 615.5133(f) would require stress testing on all investments held in an institution's portfolio. Accordingly, we propose to delete the specific stress-testing requirement for mortgage securities (which would be listed in redesignated § 615.5140(a)(6)).

The first category listed in existing § 615.5140(a)(5) is mortgage securities that are issued or guaranteed by the United States. In redesignated § 615.5140(a)(6), we propose to revise this category to refer to mortgage securities that are fully guaranteed or fully insured by a Government agency.[21] This change makes clear that this category includes only mortgage securities that are fully backed by the full faith and credit of the United States. If the United States Government issues a mortgage security that is not fully guaranteed or fully insured by the full faith and credit of the United States Government, it is not eligible under this category.

The second category listed in existing § 615.5140(a)(5) is Fannie Mae and Freddie Mac mortgage securities. As discussed above, the United States Government placed these two housing GSEs in conservatorship in September 2008, and their future remains uncertain. As long as they remain in conservatorship, we believe the existing 50-percent investment portfolio limit is appropriate. Accordingly, we propose no changes to this category (which would be included in redesignated § 615.5140(a)(6)) at this time. Depending on what happens to these GSEs in the future, a portfolio limit reduction or other restriction may become warranted. We invite your comments regarding revisions you believe we should make to this category of investments.

The third category listed in existing § 615.5140(a)(5) is non-Agency securities that comply with 15 U.S.C. 77d(5) or 15 U.S.C. 78c(a)(41). For the purpose of clarification, in redesignated § 615.5140(a)(6), we propose to replace the term "non-Agency"" with a reference to securities that are not fully insured or guaranteed by a Government agency, Fannie Mae, or Freddie Mac. We intend no substantive change with this clarification. Furthermore, in this preamble we continue the shorthand reference to these securities as non-Agency mortgage securities.

Under proposed § 615.5140(a)(6), a position in a non-Agency mortgage security would be eligible only if it is the senior-most position at the time of purchase. The FCA considers a position in a non-Agency mortgage security to be the senior-most position only if it currently meets both of the following criteria:

- No other remaining position in the securitization has priority in liquidation. Remaining positions that are the last to experience losses in the event of default and which share those losses pro rata meet this criterion.

- No other remaining position in the securitization has a higher priority claim to any contractual cash flows. Remaining positions that have the first priority claim to contractual cash flows (including planned amortization classes), as well as those that share on a pro rata basis a first priority claim to cash flows meet this criterion.

Institutions should be aware that the tranche that is the senior-most position at the time they are considering purchase is not necessarily the same tranche that was in the senior-most position at the time of issue. Institutions should also be careful not to be misled by the labeling of tranches as "super senior" or "senior" in a prospectus (or on market reporting services). Institutions may purchase non-Agency mortgage-backed securities (MBS) only if the securities satisfy the above two criteria at the time of purchase. Any security that would not satisfy the eligibility criteria after purchase because of the terms of the contract or because of structural issues would not be eligible.

In addition, we propose to reduce the investment portfolio limit for non-Agency mortgage securities from 15 to 10 percent to reduce the exposure in MBS that are not fully insured or guaranteed by the United States. We believe reducing exposure in this area of uninsured securities would result in a more diversified and liquid portfolio.

We note that the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, United States Securities and Exchange Commission, Federal Housing Finance Agency, and Department of Housing and Urban Development (collectively, the other agencies) have proposed a rule to implement the credit risk retention requirements of section 15G of the Securities and Exchange Act of 1934, as added by section 941 of the DFA.[22] If this proposed rule of the other agencies is finalized, it could change the risk characteristics of investments that System institutions invest in. Consequently, FCA may consider further revisions to portfolio limits at that time.[23]

Finally, we propose to eliminate commercial mortgage-backed securities, which are included in existing § 615.5140(a)(5), from the list of eligible investments. We believe that these securities pose undue risk due to the nature of the collateral underlying these securities.

g. <u>Proposed § 615.5140(a)(7) – Asset-Backed Securities</u>

Existing § 615.5140(a)(6) authorizes investments in asset-backed securities with a 20-percent investment portfolio limit. In redesignated § 615.5140(a)(7), we propose to reduce the investment portfolio limit from 20 to 15 percent, with no more than 5 percent of the investment portfolio in any one type of collateral. We propose this change because we believe that certain asset-backed securities, such as home equity loans and manufactured housing loans, present appreciable, albeit manageable, risk. We believe this reduction will help limit the exposure of System institutions in investments such as manufactured housing and home equity loans that experienced considerable stress during the financial crisis.

h. <u>Proposed § 615.5140(a)(8) – Corporate Debt Securities</u>

Existing § 615.5140(a)(7) authorizes investments in corporate debt securities, subject to a 20-percent investment portfolio limit. The provision also prohibits investments in securities that are convertible to equity securities.

In redesignated § 615.5140(a)(8), we propose to add a requirement that the securities must be senior debt securities to be eligible for purchase. We would leave the portfolio limit the same, but we would create additional diversification by requiring that no more than 10 percent of the investment portfolio be in any one of the 10 industry sectors as defined by the Global Industry Classification Standard (GICS).[24]

i. **Proposed § 615.5140(a)(9) – Diversified Investment Funds**

We propose to clarify our expectations for diversified investment funds contained in our existing § 615.5140(a)(8). We believe the term "diversified investment funds" could include closed-end funds, which are typically exchange-traded. We propose to add language stating that only open-end funds are eligible, in order to reduce the possibility that investments are purchased for potentially speculative purposes.

In addition, the existing rule imposes no investment portfolio limitation, as long as shares in each investment company comprise 10 percent or less of an institution's portfolio. Our proposal would impose a 50-percent total investment portfolio limit, with no more than 10 percent in any single fund. We believe this proposal would provide for more appropriate diversification across an institution's investment portfolio.

2. **Dodd-Frank Act Compliance**

In July 2010, to strengthen regulation of the financial industry in the wake of the financial crisis that unfolded in 2007 and 2008, the President signed into law the Dodd-Frank Act. Section 939A of the DFA requires the following:

- Each Federal agency must review (i) all of its regulations that require the use of an assessment of the creditworthiness of a security or money market instrument, and (ii) any references to or requirements in its regulations regarding credit ratings.

- Each Federal agency must modify its regulations to remove any reference to or requirement of reliance on credit ratings and to substitute in the regulations such standards of creditworthiness as the agency determines is appropriate. In making this determination, the agency must seek to establish, to the extent feasible, uniform standards of creditworthiness.

We have completed our review of FCA regulations that impose creditworthiness requirements or that refer to or require the use of credit ratings. Existing § 615.5140(a) is one such regulation; it requires minimum NRSRO[25] credit ratings for many categories of investments -– including municipal securities, certain money market instruments, non-Agency mortgage securities, asset-backed securities, and corporate debt securities -- in order for them to be eligible.

There are a number of different ways to assess creditworthiness, and we are considering which approach or combination of approaches would be most appropriate in this context. It may well be that we would want to propose several of these approaches in concert with one another. In the discussion below, we explore various approaches that could be considered for assessing creditworthiness as a determinant of eligibility for purposes of § 615.5140(a).[26]

First, our regulation could specify financial measurements, benchmark indexes, and other measurable criteria against which institutions could evaluate the creditworthiness of their investments. The regulation could specify factors and standards of criteria for various classes of investments. Institutions would need to ensure that these criteria were met in order for an investment to be eligible or suitable at the time of purchase. Some of the factors that could be considered as criteria to ensure a high quality, highly liquid investment portfolio include:

- Credit spreads (i.e., whether it is possible to demonstrate that a position in certain investments is subject to a minimal amount of credit risk based on the spread between the security's yield and the yield of Treasury or other securities, or based on credit default swap spreads that reference the security);

- Default statistics (i.e., whether providers of credit information relating to securities express a view that specific securities have a probability of default consistent with other securities with a minimal amount of credit risk);

- Inclusion on an index (i.e., whether a security, or issuer of the security, is commonly included as a component of a recognized index of instruments that are subject to a minimal amount of credit risk);

- Priorities and enhancements (i.e., the extent to which a security includes credit enhancement features, along with an evaluation of the relative strength of the enhancements, such as overcollateralization and reserve accounts, or has priority under applicable bankruptcy or creditors' rights provisions);

- Price, yield and/or volume (i.e., whether the price and yield of a security or a credit default swap that references the security are consistent with other securities that are subject to a minimal amount of credit risk and whether the price resulted from active trading); and

- Asset class-specific factors (e.g., in the case of structured finance products, the risk characteristics of the specific underlying collateral).

Is this approach one that FCA should consider, and are there other criteria that should be included? Should the creditworthiness standard include specific standards for probability and loss given default? If so, why, and where could the Agency source such data to derive such probabilities? Also, should this vary by asset class and/or type of investment? Finally, would it be appropriate to combine this approach with one or more of the other approaches, and if so, which ones, and why?

Second, our regulation could require System institutions to develop their own internal assessment process for evaluating the creditworthiness of investments. We believe that the level of due diligence needed to validate such a system could require significant effort on the part of System institutions. In addition, the internal evaluation system would need to be validated and might need to be frequently recalibrated based on changes in the marketplace. Institutions would need to be able to demonstrate to FCA that the probability of default characteristics and loss given default characteristics are verifiable and accurate. Any internal assessment would also have to consider an investment's marketability, liquidity, and pricing risk for determining eligibility and suitability.

The System has developed a standardized 14-point risk rating summary that institutions use to classify their loan portfolios. Similar criteria could possibly be used in the assessment of whether an investment is eligible or suitable for the portfolio. However, additional validation would likely be needed to ensure appropriate recognition of the critical factors present in investments.

Is this second approach one that we should consider? Do System institutions have the capability of validating an internal assessment system for investments, and is it appropriate to allow institutions to develop their own internal model for assessing creditworthiness of investments? If so, what standards of creditworthiness should be included, and why? If we consider an internal model approach, what would be the criteria for eligibility, and why? Also, should an assessment of creditworthiness link directly to a bank's loan rating system and if so, how should differences in classifications pertaining to eligibility be handled? Finally, would it be appropriate to combine this approach with one or more of the other approaches and, if so, which ones, and why?

Third, FCA could develop regulations that would require institutions to use third party assessments to assess creditworthiness. Organizations other than NRSROs may have the capability to evaluate creditworthiness, and this evaluation could be considered in an institution's eligibility and suitability assessment. We also believe that the DFA does not prohibit System institutions from looking to the NRSROs as a tool for assessing creditworthiness. Institutions that do so, however, should evaluate the quality of third party assessments by considering whether issuers or investors pay the rating fees. Moreover, as we have seen in the recent crisis, reliance on third party analysis can be problematic and cannot be used in isolation. Accordingly, if we were to require this approach, it would likely be in concert with one or more of the other approaches.

Is this third approach one that we should consider? What reliable third party sources exist? Would it be appropriate to combine this approach with one or more of the other approaches and if so, which ones, and why?

Fourth, FCA could develop a set of clearly defined criteria from which we would create a scale that ranks creditworthiness. We would then require System institutions to conduct due diligence to ensure that an investment they purchase actually complies with the criteria. The criteria could be as follows:

Highest Standard -- Obligations must be of the highest quality with minimal credit risk. Issuers must have an extremely strong capacity to meet its long-term financial obligations and a superior ability to repay short-term debt obligations.

High Standard -— Obligations must be of a high quality and subject to very low credit risk. Issuers must have a very strong capacity to meet its long-term financial obligations and a strong ability to repay short-term debt obligations.

We recognize that these standards may be viewed differently by different System institutions. This approach would require significant due diligence and controls in place to ensure consistency. It could also result in one institution determining an investment is eligible while another may determine an investment is not eligible at the time of purchase.

Is this fourth approach one that we should consider and, if so, what definitional criteria should be used? Would it be appropriate to combine this approach with one or more of the other approaches and, if so, which ones, and why?

In considering the requirements of the Dodd-Frank Act and the reasons for its enactment, do the above approaches allow for too much subjectivity and inconsistency? Alternatively, is there an approach that would allow for objective criteria that would lead to consistency in assessing eligibility? We are also considering how difficult and costly in practice any of the potential approaches or combination of approaches would be. In addition, we are considering whether there are other approaches to assessing creditworthiness that would be more appropriate. Finally, as a related matter, we are interested in what specific methods and standards an institution should be required to apply to appropriately assess the political and economic stability of a foreign country that hosts the obligor or issuer of an eligible investment.

3. Changes to Remainder of § 615.5140

As discussed above, we propose to relocate to § 615.5140(b) the requirement, currently contained in the introductory paragraph of § 615.5140(a), that all investments must be denominated in United States dollars.

We propose to delete our existing § 615.5140(c), which requires that all eligible investments, except money market instruments, must be marketable. We expect that in an upcoming rulemaking, we will propose to include that requirement in § 615.5134.

We propose to reduce to 15 percent the 20-percent obligor limit contained in our existing § 615.5140(d)(1). We believe this reduction is appropriate because it helps to ensure diversification among obligors.

We also propose to clarify, consistent with the amendments to terminology that we propose in § 615.5140(a) and (b), that the obligor limit does not apply to obligations that are issued or guaranteed as to interest and principal by Government agencies or Government-sponsored agencies (rather than to obligations that are issued or guaranteed as to interest and principal by the United States, its agencies, instrumentalities, or corporations). We intend no substantive change with this clarification.

Obligations that are not fully insured or fully guaranteed by a Government agency or Government-sponsored agency present relatively greater risk than do obligations that are so insured or guaranteed. We also believe that money market instruments generally present more limited risk. We seek comment on whether an overall combined portfolio limit -- including all obligations except for money market instruments and those fully insured or fully guaranteed by Government agencies and Government-sponsored agencies -- would be appropriate. Should we implement such a limit and, if so, what should the limit be? In addition, in light of the concentration that can occur in the housing sector, should we consider implementing a housing sector limit? Why or why not?

G. Section 615.5141 – Stress Tests for Mortgage Securities

Because we propose to relocate our stress-testing requirements to § 615.5133(f), we also propose to remove this stand-alone, stress-testing section from our regulations.

H. Section 615.5142 – Association Investments

Section 615.5142 implements sections 2.2(10) and 2.12(18) of the Act, which require each funding bank to supervise and approve the investment activities of its affiliated associations. Section 615.5142 authorizes an association to hold eligible investments, listed in § 615.5140, with the approval of its funding bank, for the purposes of reducing interest rate risk and managing surplus short-term funds. Each bank must review annually the investment portfolio of every association that it funds.

Although funding banks are required to supervise and approve the investment activities of an association, when we adopted this regulation in 1999, we emphasized that bank oversight does not absolve an association's board and managers of their fiduciary duties to manage investments in a safe and sound manner. We stated that the fiduciary responsibilities of association boards obligate them to develop appropriate investment management policies and practices to manage the risks associated with investment activities. We also stated that each association's investment managers must fully understand the risks of its investments and make independent and objective evaluations of investments prior to purchase.[27]

In addition, we emphasized that each association with a nonagricultural investment portfolio is required to develop an investment policy that is based on its unique characteristics and that is commensurate with the nature of its investment activities and portfolio. An association must comply with all the requirements in § 615.5133 if the level or type of its investments could expose its capital to material loss.[28]

This guidance is still valid today. However, we believe additional clarification and a regulatory revision are appropriate.

As a point of clarification, although § 615.5142 permits association investments for the purpose of, in pertinent part, reducing interest rate risk, the interest rate risk of most associations is managed by their respective funding banks. Accordingly, interest rate risk at the association level is generally minimized although not completely eliminated. The use of investments for reducing interest rate risk should be commensurate with the actual interest rate risk exposure of the association. Furthermore, associations that engage in investment activities must ensure that their investments do not increase interest rate risk.

Section 615.5142 also permits associations to invest surplus short-term funds. We are concerned that an association could draw on its line of credit with its funding bank to obtain "surplus" short-term funds that it would invest in an investment with a longer term or repricing characteristics than the term and repricing characteristics of the funding. Funding a longer term investment with short-term funds creates the potential for interest rate risk. Because of this potential risk, associations must carefully manage their investments of surplus short-term funds.

Accordingly, we propose to add paragraph (b) to § 615.5142. Paragraph (b) would require that before an association purchases an eligible investment for the purpose of managing surplus short-term funds, it must ensure that the investment's repricing and maturity characteristics match the characteristics of the surplus short-term funds to be invested.

In addition, although we do not propose this as a requirement at this time, we believe that in order for an investment to be made for the purpose of managing surplus "short-term" funds, the funds generally should be invested in instruments that are "overnight" or that have maturities of 30 days or less. We seek comment on whether we should define surplus short-term funds and if so how. Further, is our belief that surplus short-term funds should only be invested in overnight investments or in investments with maturities of 30 days or less appropriate? Lastly, is our proposed limitation on the permissible characteristics of investments purchased for the purpose of managing surplus short-term funds appropriate for associations, or does it unreasonably restrict an association's ability to properly hold and manage investments?

I. Section 615.5143 – Management of Ineligible and Unsuitable Investments

Existing § 615.5143 requires an institution to dispose of an investment that is ineligible (under the § 615.5140 criteria) within 6 months unless we approve, in writing, a plan that authorizes the institution to divest the instrument over a longer period of time. An acceptable divestiture plan must require the institution to dispose of the ineligible investment as quickly as possible without substantial financial loss. Until the institution actually disposes of the ineligible investment, the institution's investment portfolio managers must report on specified matters to the board of directors at least quarterly.

During the financial crisis of the past few years, we have received numerous divestiture plans from System institutions seeking our permission to continue to retain ineligible investments. Nearly all of these plans have involved investments that have become ineligible due to credit ratings downgrades.[29]

Typically, the analyses in the divestiture plans have indicated that holding the instruments until maturity or until market conditions improve would minimize losses, compared with incurring a substantial loss with a sale in the then-current market. Moreover, the investments have not materially affected the financial capacity of the institution. Accordingly, we have approved all investment plans that we have received in at least the last 5 years.

The automatic 6-month divestiture requirement, with FCA approval needed for a longer divestiture period, has proven to be inefficient and unnecessary. The existing regulation requires institutions to expend time and effort to develop a divestiture plan, requires FCA staff to expend time and effort reviewing the plan and developing a recommendation, and requires the FCA Board to expend time and effort determining whether to approve the plan.

Accordingly, to reduce the regulatory burden on System institutions and to improve efficiency, proposed § 615.5143(b) would permit an institution to retain an investment that no longer satisfies the eligibility criteria set forth in § 615.5140 (that satisfied the criteria when purchased), without the need for FCA approval, subject to specified requirements that are summarized below.

Section 615.5143(b) would also permit an institution to retain an investment that satisfies the § 615.5140 eligibility criteria but that is not suitable because it does not satisfy the risk tolerance established in the institution's board policy pursuant to § 615.5133(c), subject to the same specified requirements.

The specified requirements that would have to be satisfied in order to retain an investment that no longer satisfies the § 615.5140 eligibility criteria or that is unsuitable are as follows:

1. The institution must notify FCA promptly in writing upon determining that the investment no longer satisfies the § 615.5140 eligibility criteria or is unsuitable;

2. The investment must not be used to fund the liquidity reserve requirement in § 615.5134;

3. The institution must include the investment in the § 615.5132 investment portfolio limit;

4. The institution must include the investment as collateral under § 615.5050 and net collateral under § 615.5301(c) at the lower of cost or market value; and

5. The institution must develop a plan to reduce risk arising from the investment.

The first requirement, regarding FCA notification, is necessary so that we can evaluate whether the institution is responding appropriately to the situation. The second and fourth requirements, regarding exclusion from the liquidity reserve and inclusion in collateral and net collateral, are warranted by safety and soundness concerns. The third condition, regarding inclusion in the investment portfolio limit under § 615.5132, is simply an express statement that we find no basis to exclude these investments from that limit. And the final requirement, regarding the development of a risk reduction plan, is necessary for safety and soundness purposes.

Proposed § 615.5143(a) provides that an investment that does not satisfy the § 615.5140 eligibility criteria at the time of purchase is ineligible. Institutions must not purchase ineligible investments. An institution that purchases an ineligible investment must notify us promptly, in writing, and must divest of the investment no later than 60 calendar days after determining that the investment is ineligible unless we approve, in writing, a plan that authorizes divestiture over a longer period of time.[30]

Although it is not stated in the regulation, we clarify here that an acceptable divestiture plan must require an institution to dispose of the investment as quickly as possible without substantial financial loss. The plan must also contain sufficient analysis to support continued retention of the investment, including its impact on the institution's capital, earnings, liquidity, and collateral position. Our decision will not be based solely on financial loss.

Until the institution divests of the investment:

1. It must not be used to fund the liquidity reserve requirement in § 615.5134;

2. It must be included in the § 615.5132 investment portfolio limit; and

3. It must not be included as collateral under § 615.5050 or net collateral under § 615.5301(c).

We believe each institution should exercise sufficient due diligence to ensure it does not purchase ineligible investments. Such a purchase would indicate weaknesses in an institution's internal controls and due diligence, and the institution should expect greater examination scrutiny if this occurs. We expect such a purchase to be extremely rare.

Proposed § 615.5143(c) would require each institution to report to its board at least quarterly on the following:

1. The status and performance of each investment that is ineligible; was eligible when purchased but now does not meet the eligibility criteria; or is unsuitable because it does not fit the institution's risk tolerance;

2. The impact that the investments described above may have on the institution's capital, earnings, liquidity, and collateral position; and

3. The terms and status of any required divestiture plan or risk reduction plan.

This reporting allows the institution's board to exercise appropriate oversight over investments that are ineligible, unsuitable, or otherwise problematic.

Finally, proposed § 615.5143(d) would reserve FCA's authority to require an institution to divest of any investment at any time for safety and soundness purposes. In using this authority, the FCA would consider the expected loss on the transaction (or transactions) and the impact on the institution's financial condition and performance. Because the proposed rule would not require divestiture of any investment that was eligible when purchased, FCA must reserve the authority to require divestiture of investments when necessary.

J. <u>Section 615.5174 – Farmer Mac Securities</u>

We propose changes to § 615.5174(d), which governs stress testing of Farmer Mac securities, which Farm Credit banks, associations, and service corporations are permitted to purchase and hold for the purposes of managing credit and interest rate risk and furthering their mission to finance agriculture. Existing § 615.5174(d) requires institutions to perform stress tests on Farmer Mac securities in accordance with the requirements of § 615.5141. It also requires institutions to divest Farmer Mac securities that fail a stress test, as required by § 615.5143.

Institutions often participate existing mortgage loans to Farmer Mac in exchange for mortgage-backed securities guaranteed by Farmer Mac. These securities are, in essence, loans that have had the credit risk transferred to Farmer Mac. The loans were not subject to the stress-testing requirements applicable to investments, and it does not seem reasonable to impose those stress-testing requirements on the securities with which the loans were exchanged. Accordingly, we propose to remove the requirement that a System institution must subject Farmer Mac securities backed by loans that the institution originated to the stress testing applicable to investments.[31] If a System institution purchases a Farmer Mac security from another System institution or from outside the System, however, the security would remain subject to the stress testing applicable to investments.[32]

In addition, because other investments would no longer have to be divested if they fail a stress test, we propose to remove this requirement for Farmer Mac securities as well.

We also propose to add a definition of the term "you" in a new § 615.5174(e), to clarify that the regulation applies to Farm Credit banks, associations, and service corporations.

Finally, throughout § 615.5174 we propose conforming changes to references to regulations we are proposing to revise, to ensure the references continue to refer to the appropriate regulatory provisions.

IV. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FCA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

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[1] Section 619.9140 of FCA regulations defines Farm Credit bank to include Farm Credit Banks, agricultural credit banks, and banks for cooperatives.

[2] Farm Credit banks use the Federal Farm Credit Banks Funding Corporation (Funding Corporation) to issue and market System-wide debt securities. The Funding Corporation is owned by the Farm Credit banks.

[3] Section 615.5142 authorizes associations to hold eligible investments with the approval and oversight of their funding banks, for specified purposes. Associations that hold investments, as well as service corporations that hold investments, are subject to our investment management regulation at § 615.5133.

[4] We expect to propose revisions to § 615.5134 in an upcoming rulemaking.

[5] § 615.5134(a).

[6] FCA Bookletter BL-064, Farm Credit System Investment Asset Management (December 9, 2010). This Bookletter may be viewed at www.fca.gov. Under Quick Links, click on Bookletters.

[7]FCA has consistently taken this position. See, e.g., 70 FR 51587, August 31, 2005; 58 FR 63039, November 30, 1993.

[8]Under § 615.5134(b), all investments that a bank holds for the purpose of meeting the liquidity reserve requirement must be free of lien.

[9]A System workgroup has recommended the establishment of a minimum level of cash and/or investments in Treasury securities as part of the liquidity reserve requirement of Farm Credit banks. FCA expects to propose revisions to § 615.5134, governing this liquidity reserve requirement, in an upcoming rulemaking.

[10]Cash, which is also held for liquidity, also has a negative carry, but it is not subject to the 35-percent investment limit, and so it does not pose the same challenge.

[11]This rule would supersede the guidance contained in Bookletter BL-064.

[12]See 64 FR 28893, May 28, 1999.

[13]Id.

[14]Existing § 615.5135 already requires Farm Credit banks to include investments in their interest rate shock analysis. Farm Credit banks may wish to review an advisory on interest rate risk management, issued by certain other agencies in January 2010, that discusses stress testing. See, Advisory on Interest Rate Risk Management, issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Financial Institutions Examination Council State Liaison Committee (January 6, 2010).

[15]See 64 FR 28884 (May 28, 1999).

[16]In this context, "purchase" would include an acquisition such as a swap of one security in exchange for another. It would not include an acquisition through a merger or consolidation of institutions. This interpretation is consistent with our interpretation of the existing rule.

[17]Investments that do not meet our eligibility criteria that are acquired through a merger or consolidation would also be subject to the requirements of § 615.5143(b).

[18]We use the term "Obligations of the United States" to refer to obligations that are fully and explicitly insured or guaranteed by the full faith and credit of the United States. Although the United States Government placed Fannie Mae and Freddie Mac in conservatorship in September 2008 and has taken certain actions to effectively provide protection to the holders of obligations issued and guaranteed by the GSEs, these obligations are not explicitly insured or guaranteed by the United States Government's full faith and credit.

[19]As discussed above, in § 615.5131 we propose to define Government agency as "the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations are fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States."

[20]As discussed above, in § 615.5131 we propose to define Government-sponsored agency as "an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the United States Congress but whose obligations are not explicitly insured or guaranteed by the full faith and credit of the United States Government, including but not limited to any Government-sponsored enterprise."

[21]As discussed above, in § 615.5131 we propose to define Government agency as "the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations are fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States."

[22]See 76 FR 24090 (April 29, 2011).

[23]Future revisions could include changes to the portfolio limits for asset-backed securities contained in proposed § 615.5140(a)(7), as well as to changes to the portfolio limits for non-Agency mortgage securities contained in proposed § 615.5140(a)(6).

[24]GICS was developed by Morgan Stanley Capital International and Standards and Poor's. The GICS is an industry analysis framework for investment research portfolio management and asset allocation. The GICS structure consists of 10 sectors, 24 industry groups, 68 industries, and 154 sub-industries. More information can be found at www.mscibarra.com/products/indices/gics.

[25]Nationally recognized statistical rating organization.

[26]In addition, existing § 615.5140(b), which we propose to redesignate as § 615.5140(c), provides that whenever the obligor or issuer of an eligible investment is located outside the United States, the host country must maintain the highest sovereign rating for political and economic stability by an NRSRO. The DFA requires us to replace that NRSRO standard with an appropriate substitute. The following discussion also applies to that provision.

[27]See 64 FR 28885-28886 (May 28, 1999).

[28]Id.

[29]As discussed elsewhere in this preamble, section 939A of the Dodd-Frank Act requires us to remove credit ratings from our eligibility criteria and to substitute other appropriate standards of creditworthiness. We are currently asking questions about how best to develop appropriate creditworthiness standards to include in our eligibility criteria in § 615.5140. Once we have revised our eligibility criteria, a credit-rating downgrade would no longer cause an investment to fail to satisfy the criteria, but an inability to meet the new creditworthiness standards would cause an investment to fail to satisfy the criteria.

[30]In this context, "purchase" would include an acquisition such as a swap of one ineligible security for another. It would not include an acquisition through a merger or consolidation of institutions. Investments that do not meet our eligibility criteria that are acquired through a merger or consolidation would be subject to the requirements of § 615.5143(b).

[31]Institutions remain subject to the stress-testing expectations we set forth in our Informational Memorandum dated March 4, 2010. These expectations apply to all sources of risk to an institution's balance sheet, including but not limited to loans and investments.

[32]As discussed above, we propose to move the investment stress-testing requirements from § 615.5141 to § 615.5133(f).

<u>List of Subjects in 12 CFR Part 615</u>

Accounting, Agriculture, Banks, banking, Government securities, Investments, Rural areas.

For the reasons stated in the preamble, part 615 of chapter VI, title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 615--FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS, AND FUNDING OPERATIONS

1. The authority citation for part 615 is revised to read as follows:

<u>Authority</u>: Secs. 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.3, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b-6, 2279aa, 2279aa-3, 2279aa-4, 2279aa-6, 2279aa-7, 2279aa-8, 2279aa-10, 2279aa-12); sec. 301(a) of Pub. L. 100-233, 101 Stat. 1568, 1608; sec. 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat 1326, 1887 (15 U.S.C. 78o-7 note) (July 21, 2010).

<u>Subpart E--Investment Management</u>

2. Section 615.5131 is amended by:
a. Removing designations for paragraphs (a) through (l); and
b. Adding alphabetically two new definitions to read as follows:

§ 615.5131 <u>Definitions</u>.
*** * * * ***

<u>Government agency</u> means the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations <u>are</u> fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States Government.

<u>Government-sponsored agency</u> means an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the United States Congress but whose obligations <u>are not</u> explicitly insured or guaranteed by the full faith and credit of the United States Government, including but not limited to any Government-sponsored enterprise.
*** * * * ***

3. Section 615.5132 is amended by adding a new sentence at the end to read as follows:

§ 615.5132 <u>Investment purposes</u>.

*** * *** Eligible investments listed under § 615.5140 that are pledged by a Farm Credit bank to meet margin requirements for derivative transactions may be excluded when calculating the amount of eligible investments held by the Farm Credit bank pursuant to this section.

4. Revise § 615.5133 to read as follows:

§ 615.5133 <u>Investment management</u>.

(a) *<u>Responsibilities of board of directors</u>*. Your board of directors must adopt written policies for managing your investment activities. Your board must also ensure that management complies with these policies and that appropriate internal controls are in place to prevent loss. At least annually, the board, or a designated committee of the board, must review and affirmatively validate the sufficiency of these investment policies. Any changes to the policies must be adopted by the board.

(b) *Investment policies--general requirements*. Your board's written investment policies must address the purposes and objectives of investments; risk tolerance; delegations of authority; internal controls; due diligence to determine eligibility, suitability, and the value of investments; and reporting requirements. Furthermore, your investment policies must address the means for reporting, and approvals needed for, exceptions to established policies. Investment policies must be sufficiently detailed, consistent with, and appropriate for the amounts, types, and risk characteristics of your investments. You must document in your records or board minutes any analyses used in formulating your policies or amendments to the policies.

(c) *Investment policies--risk tolerance*. Your investment policies must establish risk and concentration limits for the various types, classes, and sectors of eligible investments and for the entire investment portfolio. These policies must ensure that you maintain appropriate and prudent diversification of your investment portfolio. Risk limits must be based on your institutional objectives, capital position, and risk tolerance. Your policies must identify the types and quantity of investments that you will hold to achieve your objectives and control credit, market, liquidity, and operational risks. Each association or service corporation that holds significant investments and each bank must establish risk limits in its investment policies for the following four types of risk.

(1) *Credit risk*. Investment policies must establish:

(i) *Credit quality standards, limits on counterparty risk, and risk diversification standards that limit concentrations as follows*. Concentration limits must be based on a single or related counterparty(ies). Concentration limits must also be based on a geographical area, industries or sectors, asset classes, or obligations with similar characteristics.

(ii) *Criteria for selecting brokers, dealers, and investment bankers (collectively, securities firms)*. You must buy and sell eligible investments with more than one securities firm. As part of your review of your investment policies required under paragraph (a) of this section, your board of directors, or a designated committee of the board, must review the criteria for selecting securities firms. Any changes to the criteria must be approved by the board. Also, as part of your review required under paragraph (a) of this section, the board, or a designated committee of the board, must review your existing relationships with securities firms and determine whether to continue your relationships with them. Any chang(d)es to the existing relationships with securities firms must be approved by the board.

(iii) *Collateral margin requirements on repurchase agreements*. You must regularly mark the collateral to market and ensure appropriate controls are maintained over collateral held.

(2) *Market risk*. Investment policies must set market risk limits for specific types of investments and for the investment portfolio. Your board of directors must establish market risk limits in accordance with these regulations (including, but not limited to, § 615.5135 and paragraph (f)(2) of this section) and our other policies and guidance.

(3) *Liquidity risk*. Investment policies must describe the liquidity characteristics of eligible investments that you will hold to meet your liquidity needs and institutional objectives.

(4) *Operational risk*. Investment policies must address operational risks, including delegations of authority and internal controls in accordance with paragraphs (d) and (e) of this section.

(d) *Delegation of authority*. All delegations of authority to specified personnel or committees must state the extent of management's authority and responsibilities for investments.

(e) *Internal controls*. You must:

(1) Establish appropriate internal controls to detect and prevent loss, fraud, embezzlement, conflicts of interest, and unauthorized investments.

(2) Establish and maintain a separation of duties and supervision between personnel who execute investment transactions and personnel who post accounting entries, reconcile trade confirmations, report compliance with investment policy, and approve, revalue, and oversee investments.

(3) Maintain management information systems that are appropriate for the level and complexity of your investment activities.

(4) Implement an effective internal audit program to review, at least annually, your investment controls, processes, and compliance with FCA regulations and other regulatory guidance. Your internal audit program must specifically include a review of your process for ensuring all investments, at the time of purchase, are eligible and suitable for purchase under your board's investment policies.

(f) *Due diligence to determine eligibility, suitability, and value of investments*.

(1) *Eligibility and suitability for purchase*. Before you purchase an investment, you must conduct sufficient due diligence to determine whether it is eligible under § 615.5140 and suitable for purchase under your board's investment policies. You must verify the value of the investment (unless it is a new issue) with a source that is independent of the broker, dealer, counterparty or other intermediary to the transaction. Your investment policies must fully address the extent of pre-purchase analysis that management must perform for various classes of investments. You must document your assessment of eligibility and suitability, including the information used in your assessment. You may use all sources available to you, including third party sources, to assess the investment. Your assessment of each investment at the time of purchase must at a minimum include an evaluation of credit risk, liquidity risk, market risk, and interest rate risk, and an assessment of the cash flows and the underlying collateral of the investment.

(2) *Pre-purchase and quarterly stress testing*.

(i) Prior to purchasing an investment, you must stress test it, in accordance with paragraph (f)(2)(iii) of this section, as defined in your board policy. Your board must approve the purchase of any investment that exceeds the stress-test parameters defined in your board policy.

(ii) On a quarter-end basis, you must stress test your entire investment portfolio, including a stress test of each individual investment, in accordance with paragraph (f)(2)(iii) of this section, as defined in your board policy. The policy defining the stress tests must specify what actions you will take if your portfolio exceeds the quarter-end, stress-test parameters defined in the board policy, and, at a minimum must include the development of a plan to bring your portfolio back into compliance with those parameters.

(iii) Your pre-purchase and quarter-end stress tests must be defined in a board approved policy and must include defined parameters for the types of securities you purchase. The stress tests must be comprehensive and appropriate for the risk profile of your institution. At a minimum, the stress tests must be able to measure the price sensitivity of investments over different interest rate/yield curve scenarios. The methodology that you use to analyze investment securities must be appropriate for the complexity, structure, and cash flows of the investments in your portfolio. The stress tests must enable you to determine at the time of purchase and each subsequent quarter that your investment securities, either individually or on a portfolio-wide basis, do not expose your capital, earnings, or liquidity to excessive risks. Your stress tests must enable you to evaluate the overall risk in the investment portfolio compared to your defined board policy limits. You must rely to the maximum extent practicable on verifiable information to support all your assumptions, including prepayment and interest rate volatility assumptions, when you apply your stress tests. You must document the basis for all assumptions that you use to evaluate the security and its underlying collateral. You must also document all subsequent changes in your assumptions.

(3) *Ongoing value determination*. At least monthly, you must determine the fair market value of each investment in your portfolio and the fair market value of your whole investment portfolio. In doing so you must also evaluate the credit quality and price sensitivity to the change in market interest rates of each investment in your portfolio and your whole investment portfolio.

(4) *Presale value verification*. Before you sell an investment, you must verify its value with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction.

(g) *Reports to the board of directors*.

(1) *Quarterly*. At least quarterly, your management must report on the following to your board of directors or a designated board committee:

(i) Plans and strategies for achieving the board's objectives for the investment portfolio;

(ii) Whether the investment portfolio effectively achieves the board's objectives;

(iii) The current composition, quality, and liquidity profile of the investment portfolio;

(iv) The performance of each class of investments and the entire investment portfolio, including all gains and losses that you incurred during the quarter on individual investments that you sold before maturity and why they were liquidated;

(v) Potential risk exposure to changes in market interest rates as identified through quarterly stress testing and any other factors that may affect the value of your investment holdings;

(vi) How investments affect your capital, earnings, and overall financial condition;

(vii) Any deviations from the board's policies (must be specifically identified); and(viii) The results of your quarterly stress test.

(2) *Special*. You must provide immediate notification to your board of directors or to a designated board committee if your portfolio exceeds the quarterly stress test parameters defined in the board policy required by paragraph (f)(2)(ii) of this section.

5. Revise §§ 615.5135, 615.5136 and 615.5140 to read as follows:

§ 615.5135 Management of interest rate risk.

(a) The board of directors of each Farm Credit Bank, bank for cooperatives, and agricultural credit bank must develop and implement an interest rate risk management program as set forth in subpart G of this part.

(b) The board of directors of each Farm Credit Bank, bank for cooperatives, and agricultural credit bank must adopt an interest rate risk management section of an asset/liability management policy that establishes interest rate risk exposure limits as well as the criteria to determine compliance with these limits. At a minimum, the interest rate risk management section must establish policies and procedures for the bank to:

(1) Address the purpose and objectives of interest rate risk management;

(2) Identify and analyze the causes of risks within its existing balance sheet structure;

(3) Measure the potential impact of these risks on projected earnings and market values by conducting interest rate shock tests and simulations of multiple economic scenarios at least on a quarterly basis and by considering the impact of investments on interest rate risk based on the results of the stress testing required under § 615.5133(f)(2);

(4) Describe, explore, and implement actions needed to obtain its desired risk management objectives;

(5) Document the objectives that the bank is attempting to achieve by purchasing eligible investments that are authorized by § 615.5140 of this subpart;

(6) Evaluate and document, at least quarterly, whether these investments have actually met the objectives stated under paragraph (b)(5) of this section;

(7) Identify exception parameters and approvals needed for any exceptions to the requirements of the board's policies;

(8) Describe delegations of authority;

(9) Describe reporting requirements, including exceptions to limits contained in the board's policies;

(10) Consider the nature and purpose of derivative contracts and establish counterparty risk thresholds and limits for derivatives used to manage interest rate risk.

(c) At least quarterly, management of each Farm Credit Bank, bank for cooperatives, or agricultural credit bank must report to its board of directors, or a designated committee of the board, describing the nature and level of interest rate risk exposure. Any deviations from the board's policy on interest rate risk must be specifically identified in the report and approved by the board.

§ 615.5136 Emergencies impeding normal access of Farm Credit banks to capital markets.

An emergency shall be deemed to exist whenever a financial, economic, agricultural or national defense crisis could impede the normal access of Farm Credit banks to the capital markets. Whenever the Farm Credit Administration determines, after consultation with the Federal Farm Credit Banks Funding Corporation to the extent practicable, that such an emergency exists, the Farm Credit Administration Board may, in its sole discretion, adopt a resolution that:

(a) Modifies the amount, qualities, and types of eligible investments that Farm Credit Banks, banks for cooperatives and agricultural credit banks are authorized to hold pursuant to § 615.5132 of this subpart;

(b) Modifies or waives the liquidity reserve requirement in § 615.5134 of this subpart; and/or

(c) Authorizes other actions as deemed appropriate.

§ 615.5140 Eligible investments.

(a) You may purchase only the investments that satisfy the eligibility criteria in this section. An investment that does not satisfy the eligibility criteria at the time of purchase is not eligible for purchase and is subject to the requirements of § 615.5143(a) if purchased. An investment that satisfies the eligibility criteria at the time of purchase but subsequently fails to satisfy the eligibility criteria is subject to the requirements of § 615.5143(b).

Investment Eligibility Criteria Table

Asset Class	Final Maturity Limit	NRSRO Credit Rating	Other Requirements	Investment Portfolio Limit
(1) Obligations of the United States Obligations (except mortgage securities) fully insured or guaranteed by a Government agency	None	NA	None	None
(2) Obligations of Government-sponsored agencies Government-sponsored agency securities (except mortgage securities) Other obligations (except mortgage securities) fully insured or fully guaranteed by Government-sponsored agencies	None	NA	Senior debt securities only	None
(3) Municipal Securities				
• General obligations	10 years	One of the highest two	None	15 percent
• Revenue bonds	5 years	Highest	At the time of purchase, you must document that the issue is actively traded in an established secondary market	15 percent
(4) International and Multilateral Development Bank Obligations	10 years	None	The United States must be a voting shareholder	15 percent
(5) Money Market Instruments				
• Federal funds	1 day or continuously callable up to 100 days	One of the two highest short-term	None	None
• Negotiable certificates of deposit	1 year		None	None
• Bankers acceptances	None		Issued by a depository institution	None
• Commercial paper	270 days	Highest short-term		None
• Non-callable Term Federal funds and Eurodollar time deposits	100 days		None	20 percent
• Master notes	270 days			20 percent
• Repurchase agreements collateralized by eligible investments or marketable securities rated in the highest credit rating category by an	100 days	NA		None

NRSRO				
(6) Mortgage Securities				
• Fully insured or guaranteed by a Government agency	None	NA		None
• Fannie Mae or Freddie Mac mortgage securities	None	NA		50 percent
• Securities that are not fully insured or fully guaranteed by a Government agency, Fannie Mae, or Freddie Mac and that comply with 15 U.S.C. 77d(5) or 15 U.S.C. 78c(a)(41)	None	Highest	Senior-most position only	10 percent
(7) Asset-Backed Securities secured by: Credit card receivables Automobile loans Home equity loans Wholesale automobile dealer loans Student loans Equipment loans Manufactured housing loans	None	Highest	5-year WAL for fixed rate or floating rate ABS at their contractual interest rate caps 7-year WAL for floating rate ABS that remain below their contractual interest rate cap	15 percent in total and no more than 5 percent of any single collateral type
(8) Corporate Debt Securities	5 years	One of the two highest	Senior debt securities only Cannot be convertible to equity securities	20 percent in total, and no more than 10 percent in any one of the 10 industry sectors as defined by the Global Industry Classification Standard (GICS)
(9)Diversified Investment Funds Shares of an investment company registered under section 8 of the Investment Company Act of 1940	NA	NA	Open-end funds only The portfolio of the investment company must consist solely of eligible investments authorized by §§ 615.5140 and 615.5174. The investment company's risk and return objectives and use of derivatives must be consistent with FCA guidance and your investment policies.	50 percent in total. No more than 10 percent in any single fund; otherwise counts towards limits for each type of investment.

(b) *Denomination*. All investments must be denominated in United States dollars.

(c) *Rating of foreign countries*. Whenever the obligor or issuer of an eligible investment is located outside the United States, the host country must maintain the highest sovereign rating for political and economic stability by an NRSRO.

(d) *Obligor limits.*

(1) *General.* You may not invest more than 15 percent of your total capital in eligible investments issued by any single institution, issuer, or obligor. This obligor limit does not apply to obligations, including mortgage securities, that are issued or guaranteed as to interest and principal by Government agencies or Government-sponsored agencies.

(2) *Obligor limits for your holdings in an investment company*. You must count securities that you hold through an investment company towards the obligor limit of this section unless the investment company's holdings of the security of any one issuer do not exceed five (5) percent of the investment company's total portfolio.

(e) *Other investments approved by the FCA.* You may purchase and hold other investments that we approve. Your request for our approval must explain the risk characteristics of the investment and your purpose and objectives for making the investment.

§ 615.5141 [Removed]

6. Section 615.5141 is removed.

7. Section 615.5142 is amended by:

a. Adding the designation (a) to the existing paragraph; and

b. Adding a new paragraph (b) to read as follows:

§ 615.5142 Association investments.

(a) *** * ***

(b) Before an association purchases an eligible investment for the purpose of managing surplus short-term funds, it must ensure that the investment's repricing and maturity characteristics match the characteristics of the surplus short-term funds to be invested.

8. Section 615.5143 is revised to read as follows:

§ 615.5143 Management of ineligible and unsuitable investments.

(a) *Investments ineligible when purchased.* Investments that do not satisfy the eligibility criteria set forth in § 615.5140 at the time of purchase are ineligible. You may not purchase ineligible investments. If you determine that you have purchased an ineligible investment, you must notify us promptly in writing after such determination. You must divest of the investment no later than 60 calendar days after you determine that the investment is ineligible unless we approve, in writing, a plan that authorizes you to divest the investment over a longer period of time. Until you divest of the investment:

(1) It must not be used to fund the liquidity reserve necessary to meet the liquidity reserve requirement in § 615.5134;

(2) It must be included in the § 615.5132 investment portfolio limit; and

(3) It must not be included as collateral under § 615.5050 or net collateral under § 615.5301(c).

(b) *Investments that no longer satisfy eligibility criteria or are unsuitable*. If an investment (that satisfied the eligibility criteria set forth in § 615.5140 when purchased) no longer satisfies the eligibility criteria, or if an investment is not suitable because it does not fit the risk tolerance established in your board policy pursuant to § 615.5133(c), you may continue to hold it, subject to the following requirements:

(1) You must notify FCA promptly in writing upon your determination that the investment no longer satisfies the eligibility criteria contained in § 615.5140 or is not suitable;

(2) You must not use the investment to fund the liquidity reserve necessary to meet the liquidity reserve requirement in § 615.5134;

(3) You must include the investment in the § 615.5132 investment portfolio limit;

(4) You must include the investment as collateral under § 615.5050 and net collateral under § 615.5301(c) at the lower of cost or market value; and

(5) You must develop a plan to reduce the investment's risk to you.

(c) *Board reporting requirements*. You must report to your board at least quarterly on the following**:**

(1) The status and performance of each investment described in paragraphs (a) and (b) of this section.

(2) The impact that any investments described in paragraphs (a) and (b) of this section may have on your capital, earnings, liquidity, and collateral position; and

(3) The terms and status of any required divestiture plan or risk reduction plan.

(d) *Reservation of authority*. FCA retains the authority to require you to divest of any investment at any time for safety and soundness reasons. The timeframe set by FCA will consider the expected loss on the transaction (or transactions) and the impact on your financial condition and performance.

Subpart F--Property, Transfers of Capital, and Other Investments

9. Section 615.5174 is amended by:

a. Removing the reference "§ 615.5131(f)" and adding in its place, the reference "§ 615.5131" in paragraph (a); and

b. Revising paragraph (d); and

c. Adding a new paragraph (e) to read as follows:

§ 615.5174 Farmer Mac securities.

*** * * * ***

(d) *Stress Test*. You must perform stress tests, in accordance with § 615.5133(f)(2), on mortgage securities, issued or guaranteed by Farmer Mac, that are backed by loans that you did not originate.

(e) *You*. Means a Farm Credit bank, association, or service corporation.

Date: August 12, 2011

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.

76 FR 27564, 05/11/2011

Handbook Mailing HM-11-3

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 45
Docket No. OCC-2011-0008
RIN: 1557-AD43

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
12 CFR Part 237
Docket No. R-1415
RIN: 7100 AD74

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 324
RIN: 3064-AD79

FARM CREDIT ADMINISTRATION
12 CFR Part 624
RIN: 3052-AC69

FEDERAL HOUSING FINANCE AGENCY
12 CFR Part 1221
RIN: 2590-AA45

MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Farm Credit Administration (FCA); and the Federal Housing Finance Agency (FHFA).

ACTION: Notice of proposed rulemaking.

SUMMARY: The OCC, Board, FDIC, FCA, and FHFA (collectively, the Agencies) are requesting comment on a proposal to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the Agencies is the prudential regulator. This proposed rule implements sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which require the Agencies to adopt rules jointly to establish capital requirements and initial and variation margin requirements for such entities on all non-cleared swaps and non-cleared security-based swaps in order to offset the greater risk to such entities and the financial system arising from the use of swaps and security-based swaps that are not cleared.

DATES: Comments should be received on or before June 24, 2011.

ADDRESSES: Interested parties are encouraged to submit written comments jointly to all of the Agencies. Commenters are encouraged to use the title "Margin and Capital Requirements for Covered Swap Entities" to facilitate the organization and distribution of comments among the Agencies. Commenters are also encouraged to identify the number of the specific question for comment to which they are responding.

<u>Office of the Comptroller of the Currency</u>: Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or e-mail, if possible. Please use the title "Margin and Capital Requirements" to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- **Federal eRulemaking Portal – "Regulations.gov":** Go to http://www.regulations.gov. Select "Document Type" of "Proposed Rules," and in the "Enter Keyword or ID Box," enter Docket ID "OCC-2011-0008," and click "Search." On "View By Relevance" tab at the bottom of screen, in the "Agency" column, locate the Proposed Rule for the OCC, in the "Action" column, click on "Submit a Comment" or "Open Docket Folder" to submit or view public comments and to view supporting and related materials for this rulemaking action.
- Click on the "Help" tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.
- **E-mail:** regs.comments@occ.treas.gov.
- **Mail:** Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.
- **Fax:** (202) 874-5274.
- **Hand Delivery/Courier:** 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.

Instructions : You must include "OCC" as the agency name and "Docket ID OCC-2011-0008" in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this proposed rulemaking by any of the following methods:

- **Viewing Comments Electronically:** Go to http://www.regulations.gov. Select "Document Type" of "Public Submissions," and in the "Enter Keyword or ID Box," enter Docket ID "OCC-2011-0008," and click "Search." Comments will be listed under "View By Relevance" tab at the bottom of screen. If comments from more than one agency are listed, the "Agency" column will indicate which comments were received by the OCC.
- **Viewing Comments Personally:** You may personally inspect and photocopy comments at the OCC, 250 E Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.
- **Docket:** You may also view or request available background documents and project

summaries using the methods described above.

Board of Governors of the Federal Reserve System: You may submit comments, identified by Docket No. R-1415 and RIN 7100 AD74, by any of the following methods:

- **Agency Web Site**: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- **Federal eRulemaking Portal**: http://www.regulations.gov. Follow the instructions for submitting comments.
- **E-mail**: regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.
- **Fax**: (202) 452-3819 or (202) 452-3102.
- Mail: Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments will be made available on the Board's web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

Federal Deposit Insurance Corporation: You may submit comments, identified by RIN number, by any of the following methods:

- **Agency Web Site:** http://www.fdic.gov/regulations/laws/federal/propose.html. Follow instructions for submitting comments on the Agency Web Site.
- **E-mail:** Comments@FDIC.gov. Include the RIN number on the subject line of the message.
- **Mail:** Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- **Hand Delivery:** Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m.

Instructions: All comments received must include the agency name and RIN for this rulemaking and will be posted without change to http://www.fdic.gov/regulations/laws/ federal/propose.html, including any personal information provided.

Federal Housing Finance Agency: You may submit your written comments on the proposed rulemaking, identified by regulatory information number (RIN) 2590-AA45, by any of the following methods:

- **E-mail**: Comments to Alfred M. Pollard, General Counsel, may be sent by e-mail at RegComments@fhfa.gov. Please include "RIN 2590-AA45" in the subject line of the message.
- **Federal eRulemaking Portal:** http://www.regulations.gov. Follow the instructions for submitting comments. If you submit your comment to the Federal eRulemaking Portal, please also send it by e-mail to FHFA at RegComments@fhfa.gov to ensure timely receipt by the Agency. Please include ''RIN 2590-AA45" in the subject line of the message.
- **U.S. Mail, United Parcel Service, Federal Express, or Other Mail Service**: The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/ RIN 2590-AA45, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.
- **Hand Delivery/Courier**: The hand delivery address is: Alfred M. Pollard, General Counsel,

Attention: Comments/ RIN 2590-AA45, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. A hand-delivered package should be logged at the Guard Desk, First Floor, on business days between 9:00 a.m. and 5:00 p.m.

All comments received by the deadline will be posted for public inspection without change, including any personal information you provide, such as your name and address, on the FHFA website at http://www.fhfa.gov. Copies of all comments timely received will be available for public inspection and copying at the address above on government-business days between the hours of 10 a.m. and 3 p.m. To make an appointment to inspect comments please call the Office of General Counsel at (202) 414-6924.

Farm Credit Administration: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comments multiple times via different methods. You may submit comments by any of the following methods:

- **E-mail:** Send us an e-mail at reg-comm@fca.gov.
- **FCA Web site**: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- **Federal eRulemaking Portal:** http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Acting Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

OCC: Michael Sullivan, Market RAD (202) 874-3978, Kurt Wilhelm, Director, Financial Markets Group (202) 874-4479, Jamey Basham, Assistant Director, Legislative and Regulatory Activities Division (202) 874-5090, or Ron Shimabukuro, Senior Counsel, Legislative and Regulatory Activities Division (202) 874-5090, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

Board: Sean D. Campbell, Deputy Associate Director, Division of Research and Statistics, (202) 452-3761, Michael Gibson, Senior Associate Director, Division of Research and Statistics, (202) 452-2495, or Jeremy R. Newell, Senior Attorney, Legal Division, (202) 452-3239, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington , D.C. 20551.

FDIC: Bobby R. Bean, Chief, Policy Section, (202) 898-6705, John Feid, Senior Capital Markets Specialist, (202) 898-8649, Division of Risk Management Supervision, Thomas F. Hearn, Counsel, (202) 898-6967, or Ryan K. Clougherty, Senior Attorney, (202) 898-3843, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

FHFA: Robert Collender, Principal Policy Analyst, Office of Policy Analysis and Research, 202-343-1510, Robert.Collender@fhfa.gov, Peggy Balsawer, Assistant General Counsel, Office of General Counsel, 202-343-1529, Peggy.Balsawer@fhfa.gov. or James Carley, Senior Associate Director, Division of FHLBank Regulation, 202.408.2507, james.carley@fhfa.gov, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877-8339.

FCA: William G. Dunn, Acting Associate Director, Finance and Capital Markets Team, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434, Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4434, or Rebecca S. Orlich, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Background.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was enacted on July 21, 2010.[1] Title VII of the Dodd-Frank Act established a comprehensive new regulatory framework for derivatives, which the Act generally characterizes as "swaps" (which are defined in section 721 of the Dodd-Frank Act to include interest rate swaps, commodity-based swaps, and broad-based credit swaps) and "security-based swaps" (which are defined in section 761 of the Dodd-Frank Act to include single-name and narrow-based credit swaps and equity-based swaps).[2]

As part of this new regulatory framework, sections 731 and 764 of the Dodd-Frank Act add a new section 4s to the Commodity Exchange Act and a new section 15F to the Securities Exchange Act of 1934, respectively, which require the registration and regulation of swap dealers and major swap participants and security-based swap dealers and major security-based swap participants (collectively, swap entities).[3] For certain types of swap entities that are prudentially regulated by one of the Agencies,[4] sections 731 and 764 of the Dodd-Frank Act require the Agencies to adopt rules jointly for swap entities under their respective jurisdictions imposing (i) capital requirements and (ii) initial and variation margin requirements on all non-cleared swaps and non-cleared security-based swaps.[5] Swap entities that are prudentially regulated by the Agencies and therefore subject to the proposed rule are referred to herein as "covered swap entities."

Sections 731 and 764 of the Dodd-Frank Act require the CFTC and SEC to separately adopt rules imposing capital and margin requirements for swap entities for which there is no prudential regulator.[6] The Dodd-Frank Act requires the CFTC, SEC, and the Agencies to establish and maintain, to the maximum extent practicable, capital and margin requirements that are comparable, and to consult with each other periodically (but no less than annually) regarding these requirements.[7]

The capital and margin standards for swap entities imposed under sections 731 and 764 of the Dodd-Frank Act are intended to offset the greater risk to the swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared.[8] Sections 731 and 764 of the Dodd-Frank Act require that the capital and margin requirements imposed on swap entities must, to offset such risk, (i) help ensure the safety and soundness of the swap entity and (ii) be appropriate for the greater risk associated with the non-cleared swaps and non-cleared security-based swaps held as a swap entity.[9] In addition, Sections 731 and 764 of the Dodd-Frank Act require the Agencies, in establishing capital rules for covered swap entities, to take into account the risks associated with other types, classes or categories of swaps or security-based swaps engaged in, and the other activities conducted by that person that are not otherwise subject to regulation applicable to that person by virtue of the status of the person as a swap dealer or a major swap participant.[10] Sections 731 and 764 become effective not less than 60 days after publication of the final rule or regulation implementing these sections.[11]

The capital and margin requirements that must be established with respect to non-cleared derivatives under sections 731 and 764 of the Dodd-Frank Act complement changes made elsewhere in the Act that require all sufficiently standardized swaps and security-based swaps be cleared through a derivatives clearing organization or clearing agency.[12] This clearing mandate reflects the consensus of the G-20 leaders: "All standardized over-the-counter derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end of 2012 at the latest."[13]
In the derivatives clearing process, central counterparties (CCPs) manage the credit risk through a range of controls and methods, including a margining regime that imposes both initial margin and variation margin requirements on parties to cleared transactions.[14] Thus, the mandatory clearing requirement established by the Dodd-Frank Act for swaps and security-based swaps will effectively require any party to any transaction subject to the clearing mandate to post initial and variation margin to the CCP in connection with that transaction.

However, if a particular swap or security-based swap is not cleared because it is not subject to the mandatory clearing requirement (or because one of the parties to a particular swap or security-based swap is eligible for, and uses, an exemption from the mandatory clearing requirement), that swap or security-based swap will be a "non-cleared" swap or security-based swap and will be subject to the capital and margin requirements for such transactions established under sections 731 and 764 of the Dodd-Frank Act.

The comprehensive derivatives-related provisions of title VII of the Dodd-Frank Act, including sections 731 and 764, are intended in general to reduce risk, increase transparency, promote market integrity within the financial system, and, in particular, address a number of weaknesses in the regulation and structure of the derivatives markets that were revealed during the financial crisis experienced in 2008 and 2009. During the financial crisis, the opacity of derivatives transactions among dealer banks and between dealer banks and their counterparties created uncertainty about whether market participants were significantly exposed to the risk of a default by a swap counterparty. By imposing a regulatory margin requirement on non-cleared swaps, the Dodd-Frank Act will reduce the uncertainty around the possible exposures arising from non-cleared swaps.

The recent financial crisis also revealed that some participants in the derivatives markets had used derivatives to take on excessive risks. By imposing a minimum margin requirement on non-cleared derivatives, sections 731 and 764 of the Dodd-Frank Act will reduce the ability of firms to take on excessive risks through swaps without sufficient financial resources to make good on their contracts. Because the Dodd-Frank Act requires that the margin requirements be based on the risks posed by the non-cleared derivatives and derivatives counterparties, firms that take significant risks through derivatives will face more stringent margin requirements with respect to non-cleared derivatives, while firms that take lower risks will face less stringent margin requirements.

II. Overview of Proposed Rule.

A. <u>Margin Requirements</u>

The Agencies have generally adopted a risk-based approach in proposing rules to establish initial and variation margin requirements for covered swap entities, consistent with the statutory requirement that these rules help ensure the safety and soundness of the covered swap entity and be appropriate for the risk to the financial system associated with non-cleared swaps and non-cleared security-based swaps held by covered swap entities. As a result, the proposed rule takes into account the relative risk of a covered swap entity's activities in establishing both (i) the minimum amount of initial and variation margin that it must collect from its counterparties and (ii) the frequency with which a covered swap entity must calculate and collect variation margin from its counterparty.

In implementing this risk-based approach, the proposed rule distinguishes among four separate types of derivatives counterparties: (i) counterparties that are themselves swap entities; (ii) counterparties that are high-risk financial end users of derivatives; (iii) counterparties that are low-risk financial end users of derivatives; and (iv) counterparties that are nonfinancial end users of derivatives.[15] These categories reflect the Agencies' preliminary belief that distinctions can be made between types of derivatives counterparties that are useful in distinguishing the risks posed by each type.

The proposed rule's initial and variation margin requirements generally apply only to the collection of minimum margin amounts by a covered swap entity from its counterparties; they do not contain specific requirements as to the amount of initial or variation margin that a covered swap entity must post to its counterparties.[16] This approach, which emphasizes the collection rather than the posting of margin, is based primarily on the Agencies' preliminary view that imposing requirements with respect to the minimum amount of margin to be collected (but not posted) is a critical aspect of offsetting the greater risk to the covered swap entity and the financial system arising from the covered swap entity's holdings of swaps and security-based swaps that are not cleared and helps ensure the safety and soundness of the covered swap entity. The proposed rule's approach would also assure that swap entities transacting with one another will effectively be collecting and posting margin with respect to those transactions as a result of the margin collection requirements imposed on each.

With respect to initial margin, the proposed rule permits a covered swap entity to select from two alternatives to calculate its initial margin requirements. A covered swap entity may calculate its initial margin requirements using a standardized "lookup" table that specifies the minimum initial margin that must be collected, expressed as a percentage of the notional amount of the swap or security-based swap. These percentages depend on the broad asset class of the swap or security-based swap.[17] Alternatively, a covered swap entity may calculate its minimum initial margin requirements using an internal margin model that meets certain criteria and that has been approved by the relevant prudential regulator.[18]

A covered swap entity adopting the first alternative generally must collect at least the amount of initial margin required under the standardized look-up table, regardless of the relative risk of its counterparty. A covered swap entity adopting the second alternative generally must collect at least the amount of initial margin required under its initial margin model. Both alternatives permit a covered swap entity to adopt a threshold amount below which it need not collect initial margin from certain types of counterparties.[19] Under the proposed rule, the maximum threshold amount permitted varies based on the relative risk posed by the counterparty, as determined by counterparty type.

With respect to variation margin, the proposed rule generally requires a covered swap entity to collect variation margin periodically in an amount that is at least equal to the increase in the value of the swap to the covered swap entity.[20] As with initial margin, a covered swap entity may adopt a threshold amount below which it need not collect variation margin from certain types of lower-risk counterparties.[21] Consistent with the approach taken to initial margin, the maximum threshold amount permitted for variation margin varies based on the relative risk of the counterparty, as determined by counterparty type. In addition, the frequency with which a covered swap entity must periodically recalculate and collect variation margin under the proposed rule also varies based on the relative risk of the counterparty, as determined by counterparty type, and generally decreases as the relative risk of the counterparty type decreases.[22]

The proposed rule's margin provisions establish only minimum requirements with respect to initial margin and variation that must be collected. Nothing in the proposed rule is intended to prevent or discourage a covered swap entity from collecting margin in amounts greater than is required under the proposed rule.

The proposed rule also specifies the types of collateral that are eligible to be collected to satisfy both the initial and variation margin requirements. Eligible collateral is generally limited to (i) immediately-available cash funds and (ii) certain high-quality, highly-liquid U.S. government and agency obligations and, in the case of initial margin only, certain government-sponsored enterprise obligations, subject to specified minimum "haircuts" for purposes of determining their value for margin purposes.[23]

Separate from the proposed rule's requirements with respect to the collection of initial and variation margin, the proposed rule also requires a covered swap entity to ensure that its counterparty segregates the initial margin that the covered swap entity posts when engaging in swap or security-based swap transactions with another swap entity.[24] The Agencies have proposed a requirement that segregation of initial margin be mandatory, not optional, for swap transactions by a covered swap entity with another swap entity in order to (i) offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and (ii) protect the safety and soundness of the covered swap entity.

B. Capital Requirements

Sections 731 and 764 of the Dodd-Frank Act also require the Agencies to issue, in addition to margin rules, joint rules on capital for covered swap entities for which they are the prudential regulator.[25] The Board, FDIC, and OCC (collectively, the banking agencies) have had risk-based capital rules in place for banks to address over-the-counter derivatives since 1989 when the banking agencies implemented their risk-based capital adequacy standards (general banking risk-based capital rules)[26] based on the first Basel Accord.[27] The general banking risk-based capital rules have been amended and supplemented over time to take into account developments in the derivatives market. These supplements include the addition of the market risk amendment to the first Basel Accord which requires banks and bank holding companies meeting certain thresholds to calculate their capital requirements for trading positions through models approved by their primary Federal supervisor.[28] In addition, certain large, complex banks and bank holding companies are subject to the banking agencies' advanced risk-based capital standards (advanced approaches rules), based on the advanced approaches of the Basel II Accord.[29]

FHFA's predecessor agencies used a similar methodology to frame the risk-based capital rules applicable to those entities now regulated by FHFA. The FCA's risk-based capital regulations for Farm Credit System institutions, except for the Federal Agricultural Mortgage Corporation (Farmer Mac), have been in place since 1988 and were updated in 2005.[30] The FCA's risk-based capital regulations for Farmer Mac have been in place since 2001 and were updated in 2006.[31]

The Basel Committee on Banking Supervision has recently revised and enhanced its capital framework for internationally active banks,[32] and the banking agencies expect to propose these changes in the United States in the near future through a separate notice of proposed rulemaking.

As described in section III.J below, the proposed rule requires a covered swap entity to comply with regulatory capital rules already made applicable to that covered swap entity as part of its prudential regulatory regime**.** As discussed further below, given that these existing regulatory capital rules already specifically take into account and address the unique risks arising from derivatives transactions and activities, the Agencies are proposing to rely on these existing rules, subject to the future notice of proposed rulemaking described above, as appropriate and sufficient to offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and to protect the safety and soundness of the covered swap entity.[33]

III. Section by Section Summary of Proposed Rule.

A. Section __.1: Authority, Purpose and Scope

Section __.1 of the proposed rule specifies the scope of swap and security-based swap transactions to which the margin requirements apply. It provides that the margin requirements apply to all non-cleared swaps and security-based swaps into which a covered swap entity enters, regardless of the type of transaction or the nature of the counterparty. It also provides that the margin requirements apply only to swap and security-based swap transactions that are entered into on or after the date on which the proposed rule becomes effective.

1. Treatment of Pre-Effective Date Derivatives

The Agencies note that it is possible that a covered swap entity may enter into swap or security-based swap transactions on or after the proposed rule's effective date pursuant to the same master netting agreement with a counterparty that governs existing swaps or security-based swaps entered into prior to the effective date. As discussed below, the proposed rules permit a covered swap entity to (i) calculate initial margin requirements for swaps and security-based swaps under a qualifying master netting agreement with the counterparty on a portfolio basis in certain circumstances, if it is using an initial margin model to do so, and (ii) calculate variation margin requirements under the proposed rule on an aggregate, net basis under a qualifying master netting agreement with the counterparty. Applying the new margin rules in such a way would, in some cases, have the effect of applying the margin rules retroactively to pre-effective-date swaps under the master agreement. Accordingly, in the case of initial margin, a covered swap entity using an initial margin model would be permitted, at its option, to calculate the initial margin requirements on a portfolio basis but include only post-effective-date derivatives in the relevant portfolio.[34] With respect to variation margin, the Agencies expect that the covered swap entity will comply with the margin requirements with respect to all swaps and security-based swaps governed by a master agreement, regardless of the date on which they were entered into, consistent with current industry practice. The Agencies request comment on (i) what, if any, practical difficulties might be raised by the proposed approach to application of the margin requirements under master agreements governing both pre- and post-effective-date swaps and security-based swaps and (ii) whether there are alternative approaches that might better address the issues raised by such master agreements.

2. Treatment of Derivatives with Commercial End User Counterparties

Following passage of the Dodd-Frank Act, various observers expressed concerns regarding whether sections 731 and 764 of the Dodd-Frank Act authorize or require the CFTC, SEC, and Agencies to establish margin requirements with respect to transactions between a covered swap entity and a "commercial end user" (i.e., a nonfinancial counterparty that engages in derivatives activities to hedge commercial risk),[35] and have argued that swaps and security-based swap transactions with these types of counterparties should be excluded from the scope of margin requirements imposed under sections 731 and 764 because commercial firms engaged in hedging activities pose a reduced risk to their counterparties and the stability of the U.S. financial system. In addition, statements in the legislative history of sections 731 and 764 suggest that Congress did not intend, in enacting these sections, to impose margin requirements on nonfinancial end users engaged in hedging activities, even in cases where they entered into swaps or security-based swaps with swap entities.[36]

In formulating the proposed rule, the Agencies have carefully considered these concerns and statements. The plain language of sections 731 and 764 provides that the Agencies adopt rules for covered swap entities imposing margin requirements on all non-cleared swaps. Those sections do not, by their terms, exclude a swap with a counterparty that is a commercial end user.

Importantly, those sections also provide that the Agencies adopt margin requirements that (i) help ensure the safety and soundness of the covered swap entity and (ii) are appropriate for the risk associated with the non-cleared swaps and non-cleared security-based swaps it holds as a swap entity. Thus, the statute requires the Agencies to take a risk-based approach to establishing margin requirements.

The proposed rule follows this statutory framework and proposes a risk-based approach to imposing margin requirements in which nonfinancial end users are categorized as lower-risk counterparties than financial end users. In particular, the proposed rule permits covered swap entities to adopt, where appropriate, initial and variation margin thresholds below which a covered swap entity is not required to collect initial and/or variation margin from counterparties that are end users because of the lesser risk posed by these types of counterparties to covered swap entities and financial stability with respect to exposures below these thresholds. The Agencies note that this threshold-based approach is consistent with current market practices with respect to nonfinancial end users, in which derivatives dealers view the question of whether and to what extent to require margin from their counterparties as a credit decision.[37]

Under the proposed rule, a covered swap entity would not be required to collect initial or variation margin from a nonfinancial end user counterparty as long as the covered swap entity's exposures to the nonfinancial end user were below the credit exposure limits that the covered swap entity has established under appropriate credit processes and standards. The Agencies preliminarily believe that this approach is consistent with the statutory requirement that the margin requirements be risk-based, and is appropriate in light of the minimal risks that nonfinancial end users pose to the safety and soundness of covered swap entities and U.S. financial stability, particularly in cases of relatively small margin exposures.

To the extent that a covered swap entity has adopted an initial margin threshold amount or a variation margin threshold amount for a nonfinancial end user counterparty but the cumulative required initial margin or variation margin, respectively, for transactions with that end user exceeds the initial margin threshold amount or variation margin threshold amount, respectively, the covered swap entity would be required to collect the excess amount. The Agencies preliminarily believe that this approach is appropriate for the greater risk posed by such counterparties where margin exposures are relatively large.

The Agencies request comment on the appropriateness of the proposed rule's approach to a covered swap entity's transactions with nonfinancial end users and whether there are alternative approaches that would better achieve the objective of sections 731 and 764 of the Dodd-Frank Act. In particular, the Agencies note that under other provisions of the Dodd-Frank Act, nonfinancial end users that engage in derivatives to hedge their commercial risks are exempt from the requirement that all designated swaps and security-based swaps be cleared by a derivatives clearing organization or clearing agency, respectively. A major consequence of clearing a swap or security-based swap is a requirement that each party to the transaction post initial margin and variation margin to the derivatives clearing organization or clearing agency, and the exemption from the clearing requirement permits a nonfinancial end user taking advantage of the exemption to avoid posting margin to such central CCPs. Although the Dodd-Frank Act does not contain an express exemption from the margin requirement of sections 731 and 764 of the Dodd-Frank Act that is similar to the exemption for commercial end users from the mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act, the Agencies note that the proposed rule's approach to margin requirements for derivatives with nonfinancial end users could be viewed as lessening the effectiveness of the clearing requirement exemption for these nonfinancial end users as concerns margin.

In particular, the Agencies request comment on the following questions:

Question 1(a). Does the nonfinancial end user exemption from the mandatory clearing requirement suggest or require that swaps and security-based swaps involving a nonfinancial end user should or must be exempt from initial margin and variation margin requirements for non-cleared swaps and security-based swaps? 1(b) If so, upon what statutory basis would such an exemption rely? 1(c) Should that determination vary based on whether a particular non-cleared swap or non-cleared security-based swap is subject to the mandatory clearing regime or not (i.e., whether the nonfinancial end user is actually using the clearing exemption)?

Question 2. Should counterparties that are small financial institutions using derivatives to hedge their risks be treated in the same manner as nonfinancial end users for purposes of the margin requirements?

3. Effective Date

Section __.1 of the proposed rule provides that the proposed rule shall be effective with respect to any swap or security-based swap to which a covered swap entity becomes a party on or after the date that is 180 days following publication of the final rule in the Federal Register. The Agencies request comment regarding the appropriateness of this 180-day period.

The Agencies expect that covered swap entities are likely to need to make a number of changes to their current derivatives business operations in order to achieve compliance with the proposed rules, including potential changes to internal risk management and other systems, trading documentation, collateral arrangements, and operational technology and infrastructure. In addition, the Agencies expect that covered swap entities that wish to calculate initial margin using an initial margin model will need sufficient time to develop such models and obtain regulatory approval for their use. The Agencies request comment on the following implementation questions:

Question 3(a). What changes to internal risk management and other systems, trading documentation, collateral arrangements, operational technology and infrastructure or other aspects of a covered swap entity's derivatives operations will likely need to be made as part of the implementation of the proposed rule, and how much time will likely be required to make such changes? 3(b) Is the proposed rule's 180-day period sufficient?

Question 4(a). How much time will covered swap entities that wish to calculate initial margin using an initial margin model need to develop such models? 4(b) Is the proposed rule's 180-day period sufficient?

B. Section __.2: Definitions

Section __.2 of the proposed rule provides definitions of the key terms used in the proposed rule. In particular, § __.2 (i) defines the four types of swap and security-based swap counterparties that form the basis of the proposed rule's risk-based approach to margin requirements and (ii) provides other key operative terms that are needed to calculate the amount of initial and variation margin required under other sections of the proposed rule.

1. Counterparty Definitions.

The four types of counterparties defined in the proposed rule are (in order of highest to lowest risk): (i) swap entities; (ii) high-risk financial end users; (iii) low-risk financial end users; and (iv) nonfinancial end users.

a. "Swap entities."

The proposed rule defines "swap entity" as any entity that is required to register as a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant.[38] Non-cleared swaps transactions with counterparties that are themselves swap entities pose risk to the financial system because swap entities are large players in swap and security-based swap markets and therefore have the potential to generate systemic risk through their swap activities. Because of their interconnectedness and large presence in the market, the failure of a single swap entity could cause severe stress throughout the financial system.[39]

Accordingly, it is the preliminary view of the Agencies that all non-cleared swap transactions with swap entities should require margin.

b. "Financial end users" and "nonfinancial end users."

Non-cleared swap transactions with end users (i.e., those counterparties that are not themselves swap entities) can also pose risks to covered swap entities. Among end users, financial end users are considered more risky than nonfinancial end users because the profitability and viability of financial end users is more tightly linked to the health of the financial system than nonfinancial end users. Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the covered swap entity. Section __.2 of the proposed rule defines a financial end user as any counterparty, other than a swap entity, that is: (i) a commodity pool (as defined in section 1a(5) of the Commodity Exchange Act (7 U.S.C. 1a(5))); (ii) a private fund (as defined in section 202(a) of the Investment Advisors Act of 1940 (15 U.S.C. 80-b-2(a))); (iii) an employee benefit plan (as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002)); (iv) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company of 1956 (12 U.S.C. 1843(k))[40]; (v) a person that would be a commodity pool or private fund if it were organized under the laws of the United States or any State thereof; and (vi) any other person that one of the Agencies may designate with respect to covered swap entities for which it is the prudential regulator.[41]

The proposed definition of a counterparty that is a financial end user also includes any government of any foreign country or any political subdivision, agency, or instrumentality thereof.[42] The Agencies note that these types of sovereign counterparties do not fit easily into the proposed rule's categories of financial and nonfinancial end users. In comparing the characteristics of sovereign counterparties with those of financial and nonfinancial end users, the Agencies preliminarily believe that the financial condition of a sovereign will tend to be closely linked with the financial condition of its domestic banking system, through common effects of the business cycle on both government finances and bank losses, as well as through the safety net that many sovereigns provide to banks. Such a tight link with the health of its domestic banking system, and by extension with the broader global financial system, makes a sovereign counterparty similar to a financial end user both in the nature of the systemic risk and the risk to the safety and soundness of the covered swap entity. As a result, the Agencies propose to treat sovereign counterparties as financial end users for purposes of the proposed rule's margin requirements.

The proposed rule defines a nonfinancial end user as any counterparty that is an end user but is not a financial end user.

c. "High-risk financial end user" and "low-risk financial end user."

A financial end user counterparty whose derivatives activities are relatively limited and pose little or no risk is classified as a low-risk financial end user; other end user counterparties are classified as high-risk financial end users. The likelihood of a financial end user counterparty's failure with respect to a covered swap entity during stressed market conditions increases with, among other things, the size and riskiness of its derivatives activity, and the potential impact to the covered swap entity's safety and soundness increases with the size of its non-cleared swaps exposure to the end user counterparty. Accordingly, the proposed rule is structured so that a covered swap entity would generally be required to reduce its counterparty exposure through more stringent margin collection requirements with respect to non-cleared derivatives with financial end user counterparties having greater and riskier derivatives activities.

Section __.2 of the proposed rule deems a financial end user counterparty to be a low-risk financial end user only if it meets all of the following three criteria:

- Its swaps or security-based swaps fall below a specified "significant swaps exposure" threshold;
- It predominantly uses swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate, or other risk arising from the business of the counterparty; and
- It is subject to capital requirements established by a prudential regulator or state insurance regulator.[43]

With respect to the first criterion, the definition of "significant swaps exposure" under the proposed rule is very similar to the definition of "substantial counterparty exposure" proposed by the CFTC and SEC for purposes of establishing what level of swap and security-based swap counterparty exposure would require a person to register as a major swap participant or major security-based swap participant under the Commodity Exchange Act or the Securities Exchange Act, respectively, except that the threshold amounts are established at half the level that would require registration as a major swap participant or major security-based swap participant.[44] The proposed rule's definition is thus intended to capture persons that, while not having derivatives positions rising to the level requiring margin requirements and comprehensive regulation as a major swap participant, nonetheless have substantial activity in the market and are more likely to pose greater risk to covered swap entities with which they transact than persons with only minor activity in the market. The Agencies request comment on whether this definition of significant swaps exposure is appropriate, or whether an alternative threshold amount or definition would be more consistent with the purposes of sections 731 and 764 of the Dodd-Frank Act.

The second criterion of the proposed definition of a low-risk financial end user references the purpose for which the financial end user enters into swaps or security-based swaps. This criterion generally mirrors the description of hedging-related swaps and security-based swaps that are excluded for purposes of determining whether a person maintains a substantial position in swaps or security-based swaps and therefore meets the definition of a major swap participant or major security-based swap participant under the Commodity Exchange Act and Securities Exchange Act, respectively.[45] This distinction reflects the fact that persons using derivatives predominantly to hedge or mitigate risks arising from their business, rather than to speculate for profit, are likely to pose less risk to the covered swap entity (e.g., because losses on a hedging-related swap will usually be accompanied by offsetting gains on the related position that it hedges).

The third criterion of the proposed definition of low-risk financial end user references whether the financial end user is subject to regulatory capital requirements. This criterion also generally mirrors the description of certain financial companies that are excluded from one prong of the definition of a major swap participant or major security-based swap participant under the Commodity Exchange Act and the Securities Exchange Act, respectively.[46] This distinction reflects the fact that financial end users that are subject to regulatory capital requirements are likely to pose less risk as counterparties (e.g., because the requirements ensure that minimum amounts of capital will be available to absorb any losses on their derivatives transactions).

The Agencies request comment on whether the proposed rule's categorization of various types of counterparties by risk, and the key definitions used to implement this risk-based approach, are appropriate, or whether alternative approaches or definitions would better reflect the purposes of sections 731 and 764 of the Dodd-Frank Act.

<u>Question 5</u>. Do the definitions adequately identify financial end user counterparties that are high-risk and low-risk?

<u>Question 6(a)</u>. Should nonfinancial end users also be separated into high-risk and low-risk categories for purposes of the margin requirements? 6(b) If so, on what basis (e.g., in a manner similar to the classification of high-risk and low-risk financial end users)? 6(c) If so, how should the margin requirement apply differently to such high-risk and low-risk nonfinancial end users?

<u>Question 7(a)</u>. Is the classification of sovereign counterparties as financial end users appropriate in light of the risks posed by these counterparties? 7(b) If not, what other classification would be appropriate, and why?

<u>Question 8(a)</u>. Should sovereign counterparties receive their own distinct counterparty classification that is different from those classifications in the proposed rule? 8(b) If so, why? 8(c) How should the permitted uncollateralized exposures to a sovereign counterparty differ from those that are allowed for financial or nonfinancial end users?

<u>Question 9</u>. Is it appropriate to distinguish between financial and non-financial counterparties for the purpose of this risk-based approach?

<u>Question 10</u>. What other factors or tests should be used to determine the relative risk of an end user counterparty?

<u>Question 11(a)</u>. Does the proposed rule require greater clarity with respect to the treatment of U.S. federal, state, or municipal government counterparties? 11(b) If so, how should such counterparties be

treated?

Question 12. Should a counterparty that is a bank holding company or nonbank financial firm subject to enhanced prudential standards under Section 165 of the Dodd-Frank Act be treated similarly to swap entity counterparties?

The Agencies also request comment on the other definitions included in the proposed rule, including those discussed in further detail below.

C. Section __.3: Initial Margin

Section __.3 of the proposed rules specifies the manner in which a covered swap entity must calculate the initial margin requirement applicable to its swaps and security-based swaps. These initial margin requirements apply only to the amount of initial margin that a covered swap entity is required to collect from its counterparties; they do not address whether, or in what amounts, a covered swap entity must post initial margin to a derivatives counterparty. Except as described below in the summary of § __.6 of the proposed rule, the posting of initial margin by a covered swap entity to a counterparty is generally left to the mutual agreement of the covered swap entity and its counterparty. In the case where a covered swap entity enters into a swap with a counterparty that itself is a swap entity, its counterparty is likely to be subject to a regulatory margin requirement under section 731 or section 764 requiring it to collect margin from its counterparties. Thus, both parties to a non-cleared swap between two swap entities will have to collect and post margin as required by the SEC, CFTC or their prudential regulator, as applicable.[47]

1. Calculation Alternatives.

The proposed rule permits a covered swap entity to select from two alternatives for calculating its initial margin requirements. In all cases, the initial margin amount required under the proposed rule is a minimum requirement; covered swap entities are not precluded from collecting additional initial margin (whether by contract or subsequent agreement with the counterparty) when they believe it is appropriate or preferable to do so.
Under the first alternative, a covered swap entity may calculate its initial margin requirements using a standardized "lookup" table that specifies the minimum initial margin that must be collected as a percentage of the swap or security-based swap notional amount, which percentage varies depending on the broad asset class of the swap or security-based swap.[48] If the covered swap entity has entered into more than one swap or security-based swap with a counterparty (i.e., a portfolio of swaps), the aggregate minimum initial margin required on those swaps and security-based swaps would be determined by summing the minimum initial margin requirement for each individual swap.

In many cases, however, the use of a standardized table may not accurately reflect the risk of a portfolio of swaps or security-based swaps, because the swaps or security-based swaps themselves vary in ways not reflected by the standardized table or because no reduction in required initial margin to reflect offsetting exposures, diversification, and other hedging benefits is permitted, as discussed below. For this reason, the proposed rule includes a second alternative.

Under the second alternative, a covered swap entity may calculate its minimum initial margin requirements using an internal margin model that meets certain criteria and has been approved by the relevant prudential regulator.[49] Specifically, the covered swap entity must collect at least the amount of initial margin that is required under its internal model calculations (subject to any applicable initial margin threshold amount, as described below).

The Agencies request comment on whether the use of internal models or Appendix A is appropriate for the calculation of initial margin requirements. In particular, the Agencies request comment on the following questions:

Question 13. As an alternative to Appendix A, should the rule allow an alternative calculation method that would link the margin on a non-cleared swap or non-cleared security-based swap to the margin required by a derivatives clearing organization for a cleared swap or cleared security-based swap whose terms and conditions closely resemble the terms and conditions of the non-cleared swap or non-cleared security-based swap?

Question 14. Would there be enough similarity between cleared and non-cleared swaps or security-based swaps to make this approach workable?

Question 15. With respect to either alternative for calculating initial margin requirements, should swap or security-based swap positions that pose no counterparty risk to the covered swap entity, such as a sold call option with the full premium paid at inception of the trade, be excluded from the initial margin calculation?

The Agencies also request comment on whether offsetting exposures, diversification, and other hedging benefits of multiple derivatives transactions can or should be more accurately represented in Appendix A's standardized table. The Agencies note that although the use of an initial margin model will allow for significant recognition of offsetting exposures, diversification, and other hedging benefits of swap and security-based swap positions that are conducted under a qualifying master netting agreement, Appendix A's standardized table is based upon gross notional amounts and recognizes no offsetting exposures, diversification, or other hedging benefits. In particular, the gross notional amount may not accurately reflect the size or riskiness of the actual position in many circumstances. For example, with respect to a swap portfolio containing (i) a one year pay fixed and receive floating interest rate swap with a notional value of $10 million and (ii) a two year pay floating and receive fixed interest rate swap with a notional value of $10 million, an initial margin model would recognize that much of the risk of the one year swap is offset by the risk of the two year swap–changes in the level of interest rates that increase the value of the one year swap will simultaneously decrease the value of the two year swap. Under Appendix A, however, the gross notional interest rate swap position would be $20 million and the initial margin on the portfolio would be twice the initial margin of either $10 million swap even though the trades are, in fact, risk reducing.

The Agencies are concerned that the use of gross notional amounts alone in determining initial margin may not adequately recognize offsetting exposures, diversification, and other hedging benefits that are well understood as in the above example. This lack of recognition might lead to large disparities between a firm that uses a model to set initial margin and a firm that uses the standardized initial margin requirements. These disparities may give rise to significant competitive inequities between firms that do and do not adopt an approved initial margin model.

The Agencies request comment on possible changes to the standardized method of calculating initial margin requirements to better reflect the effect of offsets and hedging when swaps and security-based swaps are conducted under a qualifying master netting agreement. In particular, the Agencies seek comment on the following questions:

Question 16. Would calculating the standardized initial margin for a particular risk category by separately calculating the initial margin required on the long positions and short positions and then using only the higher of these two amounts adequately account for offsetting exposures, diversification, and other hedging benefits within a standardized initial margin framework?

Question 17. Would the method described above systematically overestimate or underestimate offsetting exposures, diversification, and other hedging benefits? Is this method prone to manipulation or other gaming concerns?

Question 18. Should the Agencies consider some degree of offset across risk categories? If so how should these offsets be determined?

Question 19. Would adjusting the gross notional amount of swap positions in a particular risk category (e.g., commodity, credit, equity, or foreign exchange/interest rate) by a net-to-gross ratio or a netting factor in a manner that is similar to the method used for adjusting potential future exposure calculations for purposes of the Federal banking agencies' risk-based capital rules adequately capture offsetting exposures, diversification, and other hedging benefits?

Question 20. Would adjustment of gross notional amounts with a net-to-gross ratio or a netting factor systematically overestimate or underestimate offsetting exposures, diversification, and other hedging benefits?

Question 21. Are there additional methods that could be used in conjunction with a standardized lookup initial margin table that adequately recognize offsetting exposures, diversification, and other hedging benefits?

Question 22(a). Are such methods transparent and implementable? 22(b) Can they be generalized across multiple risk categories and swap types?

As an alternative, the Agencies request comment on whether Appendix A should be revised to adopt a method that more fully reflects the offsetting of positions at default. For example, such a method might rely on a calculation of an adjusted gross notional amount that would reduce the amount of initial margin required when a counterparty has many offsetting trades under a qualifying master netting agreement. To calculate the adjusted gross notional amount for an asset class, one would first calculate the net notional to gross notional ratio. This netting factor would be the absolute value of the difference between the long notional contracts and the short notional contracts divided by the total gross notional amount of the contracts. This value would then be used as a type of correlation factor among the contracts. The adjusted gross notional amount would then be calculated as follows, where n is the gross notional value of trades in an asset class and "NF" is the netting factor:

$$adjusted\ gross notional = n \times \frac{\sqrt{n + n(n-1)NF}}{n}$$

The adjusted gross notional amount, rather than the gross notional amount, would then be used to calculate initial margin using Appendix A.

When the netting factor is zero, initial margin would still be required to be collected, and when the net to gross ratio is one (all positions are one way) the netting factor is also one so that the adjusted gross notional is equal to the gross notional. This method would allow offsetting transactions that reduce risk to reduce initial margin, but would not allow the offset to ever be perfect, so that initial margin would always be required to be collected. The adjusted gross notional method would be applied to the initial margin calculation by using gross notional amounts within an asset class. The Agencies seek comment on these methods, as well as alternative methods for calculating initial margin requirements under Appendix A and potential ways in which Appendix A might better capture the offsetting exposures, diversification, and other hedging benefits.

2. Initial Margin Thresholds.

As part of the proposed rule's initial margin requirements, a covered swap entity using either alternative is also permitted to establish, for counterparties that are low-risk financial end users or nonfinancial end users, a credit exposure limit below which it need not collect initial margin.[50] A covered swap entity is not permitted to establish an initial margin threshold amount for a counterparty that is either (i) a covered swap entity itself or (ii) a high-risk financial end user.[51]

This credit exposure limit is defined in the proposed rule as the initial margin threshold amount.[52] The maximum initial margin threshold amount that a covered swap entity may establish varies based on the relative risk of the counterparty, as determined by counterparty type (e.g., financial versus nonfinancial end user). With respect to a counterparty that is a low-risk financial end user, the proposed rule limits the maximum initial margin threshold amount that a covered swap entity may establish for a particular counterparty to the lower of (i) a range of $15 to $45 million or (ii) a range of 0.1 to 0.3 percent of the covered swap entity's tier 1 capital.[53] Although the Agencies have proposed a range of specific maximum initial margin threshold amounts for a counterparty that is a low-risk financial end user, the Agencies' preliminary view is that the midpoint of each range would in each case be an appropriate amount. With respect to counterparties that are nonfinancial end users, the proposed rule does not place a specific limit on the maximum initial margin threshold amount that a covered swap entity may establish.

The proposed rule allows uncollateralized exposures below the initial margin threshold amount for certain counterparties because taking uncollateralized credit exposure to counterparties is a long established business practice at the firms regulated by the Agencies. When well managed, taking on credit exposure does not automatically lead to unacceptable levels of systemic risk. Credit exposure can arise from a number of activities that regulated firms are permitted to engage in with a counterparty–making a loan, opening a committed line of credit, providing payments processing or transaction services, or engaging in swaps transactions. Although the proposal permits such credit exposure in certain circumstances, the proposed rule seeks to ensure that initial margin is collected in amounts that are appropriate to the risks posed by counterparties that are low-risk financial end users or nonfinancial end users.

The proposed rule requires that any credit exposure limit that a covered swap entity establishes as an initial threshold amount for a counterparty (i) appropriately take into account and address the credit risk posed by the counterparty and the risks of such swaps and security-based swaps and (ii) be reviewed, monitored, and approved in accordance with the swap entity's credit processes. Threshold amounts that are established in accordance with these standards are unlikely to generate meaningful risk to the safety and soundness of the covered swap entity and do not pose systemic risk.[54] In addition, in the case of counterparties that are low-risk financial end users, which the Agencies preliminarily believe pose greater risk than nonfinancial end users, the proposed rule imposes additional restrictions by limiting the maximum initial margin threshold amount that a covered swap entity may establish.

The Agencies expect that covered swap entities will establish initial margin threshold amounts only when they have meaningfully evaluated the creditworthiness of the counterparty and have made a credit and risk management decision to expose themselves to the unsecured credit of the counterparty pursuant to their generally applicable credit approval processes. The Agencies also expect that covered swap entities will monitor initial margin threshold amounts and adjust them downward to reflect any deterioration in the credit quality of the counterparty or other increase in the risks the counterparties' swaps and security-based swaps pose. Under the proposed rule, even where an initial margin threshold amount is established, the covered swap entity must still calculate the initial margin amount for the counterparty pursuant to § __.3 of the proposed rule and, to the extent that the initial margin amount exceeds the initial margin threshold amount that has been established, collect initial margin equal to the excess amount.

For those counterparties that pose the greatest threat to systemic stability by virtue of their interconnectedness and the size of their uncollateralized and potential outward exposures–namely, other swap entities and high-risk financial end users–the proposed rule does not permit any exposure to remain uncollateralized; the threshold amount is effectively zero. It is the preliminary view of the Agencies that the potential systemic risk from other swap entities should lead to an amount of initial margin being actually collected. Margin should also be collected for all non-cleared swaps and non-cleared security-based swaps with high-risk financial end users because, as previously discussed, they are more likely to default during periods of financial stress and thus pose greater systemic risk and risk to the safety and soundness of the covered swap entity.

The Agencies request comment regarding whether it is appropriate to permit covered swap entities to establish initial margin threshold amounts for certain counterparties in the manner proposed. In particular, the Agencies request comment on the following questions:

Question 23(a). Does the maximum initial margin threshold amount proposed for counterparties that are low-risk financial end users strike an appropriate balance between traditional credit extension practices and the potential for systemic risk or risk to the safety and soundness of a covered swap entity? 23(b) Should threshold amounts for nonfinancial end users be subject to a similar limit? 23(c) If so, at what maximum amount or amounts? 23(d) Do the derivatives activities and exposures of nonfinancial end users have the potential to create systemic risk, either individually or in aggregate?

Question 24. Is it appropriate for the threshold amounts to be capped at a fixed dollar amount?

Question 25. Should the rule also place a limit on the threshold amounts that a covered swap entity establishes for all counterparties in the aggregate?

Question 26(a). Is it appropriate for the threshold amounts to be determined by reference to the tier 1 or other measure of capital of a covered swap entity? 26(b) What other measures might be used to determine appropriate threshold amounts?

Question 27(a). Should the various threshold amounts be subject to an automatic adjustment for inflation on a periodic basis? 27(b) If so, what type of adjustment would be appropriate?

3. Minimum Transfer Amount.

In addition, the proposed rule provides for a minimum transfer amount for the collection of margin by covered swap entities, under which a covered swap entity need not collect initial margin from any individual counterparty otherwise required under the proposed rule until the required cumulative amount is $100,000 or more.[55]

4. Alternative Approach to Initial Margin Requirements

The Agencies also request comment on several alternative approaches to implementation of the initial margin requirements.

First, the Agencies request comment on whether the proposed rule should be augmented by (i) imposing a separate, additional requirement that a covered swap entity post initial margin to any counterparty that is an end user, including both financial and nonfinancial end users and (ii) requiring the covered swap entity to ensure that any such initial margin posted is segregated at a third-party custodian. In particular, the Agencies request comment on the following questions:

Question 28. Would requiring a covered swap entity to post initial margin to end user counterparties reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)?

Question 29. Are there alternatives that address those risks more efficiently or with greater transparency?

Question 30. Would requiring a covered swap entity to post initial margin to end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity, taking into consideration the requirement that initial margin be segregated and held with a third party custodian?

Question 31. Would requiring a covered swap entity to post initial margin to end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging initial margin?

Question 32. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Second, the Agencies request comment on whether the proposed rule should be augmented by (i) imposing a separate, additional requirement that a covered swap entity post initial margin to any end user counterparty that is a systemically significant financial institution under Title I of Dodd-Frank Act, and (ii) requiring the covered swap entity to ensure that any such initial margin posted is segregated at a third-party custodian. In particular, the Agencies request comment on the following questions:

Question 33. Would requiring a covered swap entity to post initial margin to systemically-significant end user counterparties reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)?

Question 34. Are there alternatives that address those risks more efficiently or with greater transparency?

Question 35. Would requiring a covered swap entity to post initial margin to systemically-significant end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity, taking into consideration the requirement that initial margin be segregated and held with a third party custodian?

Question 36. Would requiring a covered swap entity to post initial margin to systemically-significant end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging initial margin?

Question 37. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Third, the Agencies request comment on whether the proposed rule should establish a distinct category of covered swap entities that, because of the relatively small size of the derivatives activities and the lesser risk they pose to U.S. financial stability, would be subject to less stringent initial margin requirement. In particular, such an approach would (i) permit such "low-risk" covered swap entities to establish larger initial or additional margin threshold amounts (e.g., for counterparties that are swap entities) and (ii) not require such "low-risk" covered swap entities to comply with the segregation requirements of § __.7 of the proposed rule. Such low-risk covered swap entities could be defined by identifying a particular threshold amount of derivatives activities below which one would be considered a low-risk covered swap entity. For example, under this approach, a low-risk covered swap entity might be defined as a covered swap entity whose total positions in swaps and security-based swaps are below the applicable thresholds established by the SEC and CFTC for determining whether a firm is a major swap participant or major security-based swap participant, respectively. In particular, the Agencies request comment on the following questions:

Question 38. Would establishing a category of low-risk covered swap entity and subjecting that category to less stringent initial margin requirements enhance or reduce systemic risk?

Question 39. Would establishing a category of low-risk covered swap entity and subjecting that category to less stringent initial margin requirements raise any concerns with respect to the safety and soundness of such an entity?

Question 40. If the Agencies adopted such an approach, how should a low-risk covered swap entity be defined? Should the definition reference the thresholds established by the SEC and CFTC for determining whether a firm is a major swap participant or major security-based swap participant, or some variant of those thresholds?

Question 41. What less stringent initial margin requirements should apply to such low-risk covered swap entities? What, if any, segregation requirement should apply to such low-risk covered swap entities?

Question 42. Would such an approach encourage covered swap entities to separate their derivatives activities into multiple entities so as to avail themselves of the exemption?

Question 43. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

D. Section __.4: Variation Margin

Section __.4 of the proposed rules specifies the manner in which a covered swap entity must calculate the variation margin requirement applicable to swaps and security-based swaps it enters into. As with initial margin requirements, (i) these variation margin requirements apply only to collection of variation margin by covered swap entities from their counterparties, and not to the posting of variation margin to their counterparties,[56] and (ii) establish only a minimum amount of variation margin that must be collected, leaving covered swap entities free to collect larger amounts if they so choose. Consistent with current practice, covered swap entities and their counterparties would remain free to negotiate the extent to which a covered swap entity may be required to post variation margin to a counterparty (other than a swap entity that is itself subject to margin requirements).

The proposed rule generally requires a covered swap entity to collect variation margin from its counterparties on a periodic basis.[57] The amount of variation margin that is required to be periodically collected must be equal to or greater than (i) the cumulative mark-to-market change in value to the covered swap entity of a swap or security-based swap, as measured from the date it is entered into, less

(ii) the value of all variation margin previously collected but not returned by the covered swap entity with respect to such swap or security-based swap.[58]

1. Variation Margin Thresholds and Minimum Transfer Amounts.

Similar to the initial margin requirement under § __.3 of the proposed rule, § __.4 permits a covered swap entity to establish, for certain counterparties that are end users, a credit exposure limit that acts as a variation margin threshold below which it need not collect variation margin.[59] Although the variation margin threshold is separate from, and may be applied independently from, the initial margin threshold with respect to qualifying counterparties, the variation margin threshold amount that a covered swap entity may establish for counterparties that are low-risk financial end users is subject to the same specified maximum amount that governs initial margin threshold amounts for such counterparties. As with initial margin threshold amounts, a covered swap entity may not establish a variation margin threshold amount for counterparties that are swap entities or high-risk financial end users.

In addition, the proposed rule's variation margin requirements contain provisions similar to those governing initial margin with respect to minimum transfer amounts.

2. Aggregate Calculation of Variation Margin Requirements under a Qualifying Master Netting Agreement.

The proposed rule permits a covered swap entity to calculate variation margin requirements on an aggregate basis across all swap or security-based swap transactions with a counterparty that are executed under the same qualifying master netting agreement.[60] The proposed rule defines a qualifying master netting agreement as a legally enforceable agreement to offset positive and negative mark-to-market values of one or more swaps or security-based swaps that meet a number of specific criteria designed to ensure that these offset rights are fully enforceable, documented and monitored by the covered swap entity.[61] The Agencies request comment regarding whether permitting the aggregate calculation of variation margin requirements is appropriate and, if so, whether the proposed rule's definition of qualifying master netting agreement raises practical or implementation difficulties or is inconsistent with current market practices.

3. Frequency of Variation Margin Calculation and Collection.

The proposed rule also specifies the minimum frequency with which a covered swap entity must calculate and collect initial margin. Consistent with the approach of the proposed rule generally, the minimum frequency varies based on the systemic and safety and soundness risk of the counterparty type. Covered swap entities must calculate and collect variation margin from counterparties that are themselves swap entities or financial end users at least once per business day, and from counterparties that are nonfinancial end users at least once per week. The Agencies request comment on whether the proposed rule's approach to the frequency with which the variation margin requirements must be met is consistent with current market practices, and whether alternative approaches to imposing variation margin requirements would better reflect the purposes of section 731 and 764 of the Dodd-Frank Act.

4. Counterparty Refusal to Provide Required Variation Margin

Section __.4(e) of the proposed rule addresses potential circumstances in which a counterparty may refuse to provide required variation margin to a covered swap entity. Specifically, it provides that a covered swap entity shall not be deemed to have violated its regulatory obligation to collect required variation margin from a counterparty if the counterparty has refused or otherwise failed to provide the required variation margin to the covered swap entity and the covered swap entity has either (i) made the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction of the relevant Agency that it has made appropriate efforts to collect the required variation margin, or (ii) commenced termination of the swap or security-based based swap with the counterparty.[62] The Agencies note that, in each such case, the covered swap entity will have been required, under § __.5 of the proposed rule, to obtain the contractual right to collect such variation margin as is necessary to permit it to comply with the requirements of § __.4 of the proposed rule and set out valuation dispute resolution procedures.

5. Alternative Approach to Variation Margin Requirements

The Agencies also request comment on several alternative approaches to implementation of the variation margin requirements.
First, the Agencies request comment on whether the proposed rule should be augmented by imposing a separate, additional requirement that a covered swap entity post variation margin to any counterparty that is an end user, including both financial and nonfinancial end users. In particular, the Agencies request comment on the following questions:

Question 44. Would requiring a covered swap entity to post variation margin to end user counterparties reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)?

Question 45. Are there alternatives that address those risks more efficiently or with greater regulatory transparency?

Question 46. Would requiring a covered swap entity to post variation margin to end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity?

Question 47. Would requiring a covered swap entity to post variation margin to end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging variation margin?

Question 48. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?
Second, the Agencies request comment on whether the proposed rule should be augmented by imposing a separate, additional requirement that a covered swap entity post variation margin to any end user counterparty that is a systemically significant financial institution under Title I of Dodd-Frank Act. In particular, the Agencies request comment on the following questions:

Question 49. Would requiring a covered swap entity to post variation margin to systemically-significant end user counterparties reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)?

Question 50. Are there alternatives that address those risks more efficiently or with greater regulatory transparency?

Question 51. Would requiring a covered swap entity to post variation margin to systemically-significant end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity?

Question 52. Would requiring a covered swap entity to post variation margin to systemically-significant end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging variation margin?

Question 53. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Third, the Agencies request comment on whether the proposed rule should establish a distinct category of swap entities that, because of the relatively small size of the derivatives activities and the lesser risk they pose to U.S. financial stability, would be subject to less stringent variation margin requirement. In particular, such an approach would permit such "low- risk" covered swap entities to establish larger variation margin threshold amounts. Such low-risk covered swap entities could be defined as described in section III.C.4 of this notice. In particular, the Agencies request comment on the following questions:

Question 54. Would establishing a category of low-risk covered swap entity and subjecting such an entity to less stringent variation margin requirements enhance or reduce systemic risk?

Question 55. Would establishing a category of low-risk covered swap entity and subjecting such an entity to less stringent variation margin requirements raise any concerns with respect to the safety and soundness of such an entity?

Question 56. If the Agencies adopted such an approach, how should a low-risk covered swap entity be defined? What less stringent variation margin requirements should apply to such low risk covered swap entities?

Question 57. Would such an approach encourage covered swap entities to separate their derivatives activities into multiple entities so as to avail themselves of the exemption?

Question 58. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

E. Section __.5: Documentation of Margin Matters

The proposed rule requires a covered swap entity to execute trading documentation with each counterparty that includes credit support arrangements that grant the covered swap entity the contractual right to collect initial margin and variation margin in such amounts, in such form, and such circumstances as are required by the initial margin and variation margin requirements set forth in the proposed rule.[63] The trading documentation must also specify (i) the methods, procedures, rules, and inputs for determining the value of each swap or security-based swap for purposes of calculating variation margin requirements and (ii) the procedures by which any disputes concerning the valuation of swaps or security-based swaps, or the valuation of assets collected or posted as initial margin or variation margin, may be resolved.[64]

F. Section __.6: Eligible Collateral

The proposed rule specifies the types of collateral that are eligible to be collected to satisfy either the initial margin or variation margin requirements. Under the proposed rule, eligible collateral is limited

to: (i) immediately available cash funds (denominated in either U.S. dollars or in the currency in which payment obligations under the swap are required to be settled); (ii) any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, the United States; (iii) with respect to initial margin only, any senior debt obligations of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks and Farmer Mac; and (iv) with respect to initial margin only, any obligation that is an "insured obligation," as that term is defined in 12 U.S.C. 2277a(3), of the Farm Credit System banks.[65] Other than immediately-available cash funds, all types of eligible collateral are subject to discounts or minimum "haircuts" for purposes of determining their value for margin purposes, which haircuts are identified in Appendix B of the proposed rule.[66] Because the value of noncash collateral may vary, the proposed rule requires covered swap entities to monitor the value of noncash collateral previously collected to satisfy initial or variation margin requirements and, to the extent the value of such noncash collateral has decreased, to collect additional collateral with a sufficient value to ensure that all applicable initial and variation margin requirements remain satisfied.[67] The proposed rule also prohibits a covered swap entity from collecting, as required initial margin or variation margin, collateral that is an obligation of the counterparty pledging such collateral.[68]
The proposed rule does <u>not</u> allow for the use of non-cash collateral, other than the limited types of highly-liquid, high-quality debt securities described above, to satisfy the margin requirements. The appropriateness of using non-cash collateral to fulfill margin requirements is complicated by procyclical considerations. During a period of financial stress, the value of non-cash collateral pledged as margin may also come under stress just as counterparties default and the non-cash collateral is required to offset the cost of replacing defaulted swap positions. In addition, given the infinite variety of potential types of noncash collateral, it is extremely difficult to establish accurate haircuts by regulation. Also, for nonfinancial end users, who are the most likely type of counterparty to wish to post noncash collateral, the proposed rules provide credit exposure thresholds, under which a covered swap entity may determine the extent to which available noncash collateral appropriately reduces the covered swap entity's credit risk, consistent with its credit underwriting expertise. Similarly, counterparties that wish to rely on other non-cash assets to meet margin requirements could pledge those assets with a bank or group of banks in a separate arrangement, such as a secured financing facility, and could draw cash from that arrangement to meet margin requirements.

The Agencies request comment on whether the proposed rule's list of eligible noncash collateral for initial margin and variation margin is appropriate in scope**.** In particular, the Agencies request comment on the following questions:

<u>Question 59(a)</u>. Should the types of eligible collateral listed be broadened to include other types of assets (e.g. securities backed by high-quality mortgages or issued with a third-party guarantee)? 59(b) If so, how might the systemic risk issue described above be effectively mitigated?

<u>Question 60(a)</u>. Should the types of eligible collateral listed be broadened to include immediately-available cash funds denominated in foreign currency, even where such currency is not the currency in which payment obligations under the swap are required to be settled? 60(b) If so, which currencies (e.g., those accepted by a derivatives clearing organization as initial margin for a cleared swap)? 60(c) If so, what haircut, if any, should apply to such foreign currency?

<u>Question 61</u>. What criteria and factors could be used to determine the set of acceptable non-cash collateral?

<u>Question 62</u>. How could appropriate haircuts be determined for valuing these assets for margin purposes?

Question 63(a). Should the types of eligible collateral listed be broadened to include foreign sovereign debt securities? 63(b) If so, which foreign sovereign debt securities (e.g., those accepted by a derivatives clearing organization as initial margin for a cleared swap)? 63(c) If so, what haircut, if any, should apply?

Question 64(a). Should fixed income securities issued by a well-known seasoned issuer that has a high credit standing, are unsubordinated, historically display low volatility, are traded in highly liquid markets, and have valuations that are readily calculated be added to the list of eligible collateral for initial margin? 64(b) If so, how should the concept of a "high credit standing" be defined in a way that does not reference credit ratings?

G. Section __.7: Segregation of Collateral

The proposed rule provides that each covered swap entity must require each derivatives counterparty that it faces that is a swap entity to segregate any funds or collateral that the covered swap entity has posted as initial margin for a non-cleared swap or non-cleared security-based swap transaction at an independent, third-party custodian.[69] This independent, third-party custodian must be prohibited by contract from (i) rehypothecating or otherwise transferring any initial margin it holds for the covered swap entity and (ii) reinvesting any initial margin held by the custodian in any asset that would not qualify as eligible collateral for initial margin under the proposed rule.[70] The custodian must also be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity.[71] This segregation requirement applies only to initial margin, not variation margin, and does not apply to transactions with a counterparty that is an end user of any type.[72]

The Agencies' preliminary view is that requiring covered swap entities to ensure segregation of initial margin is necessary to (i) offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and (ii) protect the safety and soundness of the covered swap entity. In developing this proposal, the Agencies have taken into account the fact that the failure of a covered swap entity could pose significant systemic risks to the financial system and losses borne by the financial system in such a failure could have significant consequences. The consequences could be magnified if the initial margin posted to the failing swap entity cannot be quickly recovered by the nondefaulting party during a period of financial stress when the liquidity value of the funds is high. Moreover, swap entities typically have roughly offsetting exposures with one another. As a result, it is to be expected that the amount of initial margin required to be posted by two swap entities will be similar. If swap entities exchange similar amounts of initial margin and these funds are available for general use and rehypothecation by the swap entities, then the net effect is as if little initial margin was exchanged. To the extent that initial margin requirements are intended to constrain risk-taking, a lack of segregation will weaken their effect.[73]

Swap entities that engage in cleared swap transactions will be required to post initial margin to the CCP. Consequently, the initial margin that is posted on cleared transactions will not be available for rehypothecation by swap entities. Allowing for rehypothecation of initial margin by swap entities would create an incentive for swap entities to engage in non-cleared transactions even though other provisions of Dodd-Frank Act are intended to promote central clearing of swaps. However, the segregation of initial margin is likely to significantly reduce the availability of liquid assets to covered swap entities to meet payment obligations, as liquid assets held or pledged as the initial margin would be unavailable to the swap entity for other purposes. The requirement to segregate initial margin could result in covered swap entities having to seek alternative methods of funding. The loss in liquidity could be severe, and could require covered swap entities to raise liquidity through other sources.

The Agencies are concerned that not requiring segregation at the outset may cause covered swap entities that incur a severe loss due to credit or market events to face liquidity challenges because their counterparties may require segregation immediately after the loss, depleting the covered swap entity's liquid assets before it can raise additional funds through other means.[74] Requiring swap entities to segregate at the outset addresses this concern at the time a swap entity suffers a loss, but depletes the liquid assets at the inception of the swap transaction–a time when the swap entity is more likely to be able to raise additional liquid funds. The Agencies request comment on whether the proposed segregation requirement is appropriate, or whether an alternative approach would better reflect the purposes of sections 731 and 764 of the Dodd-Frank Act. In particular, the Agencies request comment on the following questions:

Question 65(a). Is it necessary to require segregation of initial margin in order to address the systemic risk issues discussed above? 65(b) What alternatives to segregation would effectively address these systemic risk issues? 65(c) As an alternative to requiring segregation at the outset, should the Agencies impose rules that provide additional time for a swap dealer to raise funds without requiring segregation?

Question 66(a). What are the potential operational, liquidity and credit costs of requiring segregation of initial margin by swap entities? 66(b) What would be the expected liquidity impact and cost of the proposed segregation requirement on market participants? How can the impact of the proposed rule on the liquidity and costs of swaps market participants be mitigated?

Question 67. Is segregation of initial margin and not variation margin sufficient to achieve the purposes of sections 731 and 764 of the Dodd-Frank Act? If not, how might such purposes be achieved?

Question 68(a). Are the limitations placed on rehypothecation and reinvestment under the proposed rule appropriate or necessary? 68(b) What additional or alternative limitations may be appropriate? 68(c) Should certain forms of rehypothecation (e.g., the lending of securities pledged as collateral) or additional types of reinvestment be permitted?

Question 69(a). Is the proposed rule's requirement that the custodian must be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity necessary or appropriate? 69(b) What additional or alternative requirements regarding the location of the custodian may be appropriate?

H. Section __.8: Approved Initial Margin Models

Section __.8 of the proposed rule contains modeling standards that an initial margin model must meet in order for a covered swap entity to calculate initial margin under such a model. Generally, the modeling standards are consistent with current regulatory rules and best practices for such models in the context of risk-based capital rules applicable to insured depository institutions and bank holding companies, and are no less conservative than those generally used by derivatives clearing organizations and clearing agencies.[75] As a result, the Agencies preliminarily believe that these modeling standards should ensure that a non-cleared swap does not pose a greater systemic risk than a cleared swap. In particular, because non-cleared swaps are expected to be less liquid than cleared swaps, the proposed rule specifies a minimum time horizon for the initial margin model of 10 business days, compared with a typical requirement of 3 to 5 business days used by derivatives CCPs.[76]

The proposed rule permits a covered swap entity to use an internal initial margin model that reflects offsetting exposures, diversification, and other hedging benefits within four broad risk categories (commodity, credit, equity, foreign exchange/interest rates) when calculating initial margin for a particular counterparty if the relevant swaps or security-based swaps are executed under the same qualifying master netting agreement.[77] The proposed rule does not permit an initial margin model to reflect offsetting exposures, diversification, or other hedging benefits across broad risk categories.[78] It is the preliminary view of the Agencies that the correlations of exposures across broad risk categories are not stable enough to be incorporated into a regulatory margin requirement.

The Agencies request comment on whether the standards for initial margin models specified in the proposed rule are sufficient to ensure the integrity of initial margin calculations using such a model. In particular, the Agencies request comment on the following questions:

Question 70(a). Should such models be limited to models based on value-at-risk concepts, or are other models appropriate to measure initial margin? 70(b) If so, how should those models apply and be incorporated into the various aspects of the proposed rule?

Question 71(a). Should offsetting exposures, diversification, and other hedging benefits be recognized more broadly across substantially dissimilar asset classes? 71(b) If so, what limits, if any, would be placed on the recognition of offsetting exposures, diversification, and other hedging benefits, and how could these be measured, monitored and validated on an ongoing and consistent basis across substantially dissimilar asset classes?

Question 72(a). Should the minimum time horizon vary across swaps? 72(b) For example, should it vary based on the broad asset classes: commodity, credit, equity, and foreign exchange/interest rate? 72(c) If so, how should the horizons differ and what would be the basis for the different horizons?

1. Stress Calibration

In addition to a time horizon of 10 trading days, the proposed rule requires the initial margin model to be calibrated to a period of financial stress.[79] Calibration to a stress period ensures that the resulting initial margin requirement is robust to a period of financial stress during which swap entities and financial counterparties are more likely to default. Such calibration also reduces the systemic risk associated with any increase in margin requirements that might occur in response to a large increase in volatility during a period of financial stress.

The Agencies request comment on whether the proposed requirement that an initial margin model take into account financial stress is appropriate given the purpose the initial margin model is intended to serve. In particular, the Agencies request comment on the following questions:

Question 73. Can initial margin models be robustly calibrated to a stress period in a transparent and consistent manner?

Question 74. Are there any other systemic risk implications of requiring that initial margin be calibrated to a period of financial stress rather than to a recent or normal historical period?

Question 75. Is the proposed prudential standard for initial margin of a 99th percentile price move over a 10 day horizon, calibrated using historical data incorporating a period of significant financial stress, appropriate?

Question 76. Is a 10-day horizon sufficient to cover the likely liquidation period on non-cleared swaps?

Question 76. Will the requirement to calibrate to a period of significant financial stress reduce the potential procyclicality of the margin requirement sufficiently? For example, would a minimum margin requirement as a backstop to the modeled initial margin amounts be a prudent approach to addressing procyclicality concerns?

Question 77. Is "period of significant financial stress" a well-understood concept? How might it be clarified?

Question 78. What would be the benefits and costs of replacing the requirement to calibrate the initial margin model using a period of significant financial stress with a requirement to calibrate the initial margin model using a longer historical data sample (such as 10 years), as an alternative way to reduce the potential procyclicality of the margin requirement?

Question 79. Should market participants be able to comply with the requirement to calibrate the initial margin requirement to a historical period of significant financial stress for newer products with little, if any, market history? If so, how?

2. Benchmarking

The proposed rule requires that an initial margin model used for calculating initial margin requirements be benchmarked periodically against observable margin standards to ensure that the initial margin required is not less than what a derivatives clearing organization or a clearing agency would require for similar transactions.[80] This benchmarking requirement is intended to insure that any initial margin amount produced by an initial margin model is subject to a readily observable minimum. It will also have the effect of limiting the extent to which the use of initial margin models might disadvantage the movement of certain types of derivatives to CCPs by setting lower initial margin amounts for non-cleared transactions than for similar cleared transactions.

The Agencies request comment on the proposed requirement for covered swap entities to benchmark any initial margin model to a model used by a derivatives clearing organization or clearing agency model for calculating initial margin, as well as the following questions:

Question 80. What are the operational costs associated with the benchmarking exercise?

Question 81. Can portfolio effects be captured during the benchmarking exercise?

Question 82. How would a banking organization fulfill the requirement in the event that a derivatives clearing organization or clearing agency does not clear a similar derivative transaction?

Section __.9: Application of Margin Requirements to Certain Foreign Covered Swap Entities

Section __.9 of the proposed rule addresses the manner in which the proposed rule's margin requirements apply to certain foreign covered swap entities. In the absence of § __.9, the proposed rule's margin requirements would apply to all of a covered swap entity's non-cleared swap and non-cleared security-based swap transactions, without regard to whether (i) the covered swap entity is organized under U.S. or foreign law or (ii) the covered swap entity's counterparty is located inside or outside of the United States. However, the potential application of the margin rules to foreign covered swap entities, or to transactions by U.S. covered swap entities with foreign counterparties, raises several important questions. First, the potential application of the proposed rule to activities conducted by a foreign covered swap entity wholly outside of the United States raises questions regarding the permissible territorial scope of the proposed rule.[81] Second, to the extent that the proposed margin requirements apply to transactions involving foreign covered swap entities or foreign counterparties, such application could subject these transactions to multiple, and potentially conflicting, margin requirements established by U.S. and foreign regulators. Third, the potentially different treatment of U.S. covered swap entities and foreign covered swap entities raises questions of competitive equality among the two types of firms.

With respect to U.S. covered swap entities, the Agencies propose to apply the margin requirements to U.S. covered swap entities' swap and security-based swap transactions without regard to whether the counterparty is located inside or outside the United States. This approach acknowledges that the foreign swap and security-based swap transactions of a U.S. covered swap entity pose no lesser risk to the covered swap entity's safety and soundness and to financial stability based on the location of the counterparty. The proposed rule applies that same approach to covered swap entities that are foreign subsidiaries and offices of U.S. firms.

With respect to foreign covered swap entities, the Agencies propose to exclude certain qualifying foreign derivative transactions of such entities from application of the proposed rule's margin requirements. Specifically, § __.9 of the proposed rule provides that the proposed rule's margin requirements would not apply to any "foreign non-cleared swap or foreign non-cleared security-based swap" of a "foreign covered swap entity," as those terms are defined in § __.9 of the proposed rule.[82] This proposed approach limits the extra-territorial application of the margin requirements while preserving, to the extent possible, competitive equality among U.S. and foreign firms in the United States.

For these purposes, the proposed rule defines a "foreign non-cleared swap or foreign non-cleared security-based swap" as a non-cleared swap or non-cleared security-based swap with respect to which: (i) the counterparty to the foreign covered swap entity is not a company organized under the laws of the United States or any State, not a branch or office of a company organized under the laws of the United States or any State, and not a person resident in the United States; and (ii) performance of the counterparty's obligations to the foreign covered swap entity under the swap or security-based swap has not been guaranteed by an affiliate of the counterparty that is a company organized under the laws of the United States or any State, a branch of a company organized under the laws of the United States or any State, or a person resident in the United States.[83] As a result, foreign swaps and security-based swaps would generally only include transactions where the counterparty is not organized under U.S. law or otherwise located in the United States, and no U.S. affiliate of the counterparty has guaranteed the counterparty's obligations under the transaction.[84]

The additional requirement that no U.S. affiliate guarantee the counterparty's obligation is intended to exclude instances where such an affiliate has, through a guarantee, effectively assumed ultimate responsibility for the performance of the counterparty's obligations under the transaction. In particular, the Agencies are concerned that without such a requirement, swaps and security-based swaps with a U.S. counterparty could be structured, through the use of an overseas affiliate, in a manner that would evade application of the proposed margin requirements to U.S. transactions. Transactions guaranteed by a U.S. affiliate would also have direct and significant connection with activities in, and effect on, commerce of the United States.

The proposed rule defines a "foreign covered swap entity" as a covered swap entity that: (i) is not a company organized under the laws of the United States or any State; (ii) is not a branch or office of a company organized under the laws of the United States or any State; (iii) is not a U.S. branch, agency or subsidiary of a foreign bank; and (iv) is not controlled, directly or indirectly, by a company that is organized under the laws of the United States or any State.[85] Accordingly, only a covered swap entity that is organized under foreign law and not controlled, directly or indirectly, by a U.S. company would be eligible for treatment as a foreign covered swap entity for these purposes; neither a foreign branch of a U.S. insured depository institution nor a foreign subsidiary of a U.S. company would be considered a foreign covered swap entity under the proposed rule. In cases where a U.S. company has a foreign subsidiary that is a covered swap entity, the proposed rule would treat that foreign subsidiary in the same manner as a U.S. covered swap entity for purposes of the margin requirements because the U.S. parent company's ownership of the subsidiary is likely to expose the U.S parent company, as a result of legal, contractual or reputational factors, to the risks of the foreign subsidiary's derivatives activities. Transactions of a foreign subsidiary of a U.S. company would also have direct and significant connection with activities in, and effect on, commerce of the United States. Similarly, neither a U.S. branch of a foreign bank nor a U.S. subsidiary of a foreign company would be a foreign covered swap entity under the proposed rule.

The Agencies request comment on the proposed rule's application to the U.S. and foreign swap and security-based swap activities of U.S. covered swap entities and foreign swap entities, respectively. In particular, the Agencies request comment on the following questions:

Question 83. Does the proposed rule's treatment of the swap and security-based swap transactions of foreign covered swap entities appropriately limit application of the margin requirements in a manner consistent with the territorial scope of sections 731 and 764 of the Dodd-Frank Act?

Question 84(a). Is the proposed rule's treatment of the foreign swap and security-based swap transactions of U.S. covered swap entities appropriate? 84(b) Should such transactions be subject to the same exclusion that has been proposed for the foreign swap and security-based swap transactions of foreign covered swap entities? 84(c) If so, why?

Question 85(a). Should the proposed rule expand the definition of foreign covered swap entity to include (i) the foreign subsidiaries of U.S. companies or (ii) the foreign branches of U.S. insured depository institutions? 85(b) If so, why? 85(c) How could the potential risks to the U.S. parent company or insured depository institution related to its subsidiary or branch's activity be limited or eliminated? 85(d) Is this operationally feasible?

Question 86. What impact is the proposed rule's treatment of the foreign swap and security-based swap transactions of U.S. covered swap entities likely to have on the structure, management, and/or competitiveness of U.S. covered swap entities?

Question 87(a). Is the proposed rule's definition of a foreign swap or security-based swap transaction appropriate? 87(b) In particular, is the requirement that no U.S. affiliate guarantee the foreign counterparty's obligations under the swap or security-based swap transaction appropriate? 87(c) Would an alternative definition more appropriately differentiate between U.S. and foreign counterparties for these purposes? 87(d) If so, what should that definition be?

Question 88(a). Is the proposed rule's definition of a foreign covered swap entity appropriate? 88(b) Would an alternative definition more appropriately differentiate between U.S. and foreign counterparties for these purposes? 88(c) If so, what should that definition be?

Question 89(a). Is the proposed rule's application of the margin requirements to all U.S. swaps and security-based swaps of a covered swap entity, regardless of whether that covered swap entity is U.S. or foreign, appropriate? 89(b) Should the proposed rule treat such transactions differently? 89(c) If so, how?

Question 90. What impact is the proposed rule's treatment of the swap and security-based swap transactions of foreign covered swap entities likely to have on the structure, management, and/or competitiveness of foreign covered swap entities?

J. Section __.10: Capital

The proposed rule generally requires a covered swap entity to comply with regulatory capital rules already made applicable to that covered swap entity as part of its prudential regulatory regime, as follows:

- In the case of insured depository institutions, the capital adequacy guidelines that are applicable to the covered entity and have been adopted by the appropriate Federal banking agency under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o);
- In the case of a bank holding company or savings and loan holding company (on or after the transfer established under Section 311 of the Dodd-Frank Act), the capital adequacy guidelines applicable to bank holding companies under the Board's Regulation Y (12 CFR Part 225);
- In the case of a foreign bank or the U.S. branch or agency of a foreign bank, the capital rules that are made applicable to such covered entity pursuant to § 225.2(r)(3) of the Board's Regulation Y (12 CFR 225.2(r)(3);
- In the case of an Edge corporation or an Agreement corporation, the capital adequacy guidelines that are made applicable to an Edge corporation engaged in banking pursuant to § 211.12(c)(2) of the Board's Regulation K (12 CFR 211.12(c)(2);
- In the case of any "regulated entity" under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (i.e., Fannie Mae and its affiliates, Freddie Mac and its affiliates, and the Federal Home Loan Banks), the risk-based capital level or such other amount applicable to the covered swap entity as required by the Director of FHFA pursuant to 12 U.S.C. 4611;
- In the case of Farmer Mac, the capital adequacy regulations set forth in 12 CFR Part 652; and
- In the case of any Farm Credit System institution (other than Farmer Mac), the capital regulations set forth in 12 CFR Part 615.[86]

The Agencies have preliminarily determined that compliance with these regulatory capital requirements is sufficient to offset the greater risk to the swap entity and the financial system arising from the use of non-cleared swaps, helps ensure the safety and soundness of the covered swap entity, and is appropriate for the greater risk associated with the non-cleared swaps and non-cleared security-based swaps held as a covered swap entity. In particular, the Agencies note that the capital rules incorporated by reference into the proposed rule already address, in a risk-sensitive and comprehensive manner, the safety and soundness risks posed by a covered swap entity's derivatives positions.[87] In addition, the Agencies preliminarily believe that these capital rules sufficiently take into account and address the risks associated with the derivatives positions that a covered swap entity holds and the other activities conducted by a covered swap entity.[88]

The Agencies request comment regarding whether application of these capital regimes is appropriate.

Question 91. Is an alternative or additional capital requirement appropriate for some or all of the covered swap entities subject to the proposed rule?

Question 92. Are there particular issues or concerns raised in the context of foreign banks or their U.S.

branches and agencies that would be better addressed through a different approach to the capital requirement for such entities?

K. Section __.11: Special Requirements for Transactions Between Swap Entities and Regulated Entities

FHFA and FCA (but not the other Agencies) are proposing an additional provision, § __.11 of FHFA's and FCA's proposed rules. Proposed § __.11 would require that any entity that is regulated by FHFA or FCA, but is not itself a covered swap entity, collect initial margin and variation margin from its counterparty when entering into a non-cleared swap or non-cleared security-based swap with a swap entity.[89] Regulated entities subject to this provision include the Federal Home Loan Banks, Fannie Mae and its affiliates, Freddie Mac and its affiliates, and all Farm Credit System institutions including Farmer Mac (collectively, regulated entities, and each a regulated entity). Regulated entities that are swap entities would be subject to §§ 1 through 9 of the proposed rule by virtue of being covered swap entities. This section also does not apply to swaps entered into between regulated entities and end users.

Proposed § __.11 is consistent with the risk-based approach to margin proposed by the Agencies and parallels the requirements that swap entities collect initial and variation margin from their counterparties. Moreover, this approach recognizes that a default by a swap counterparty to a regulated entity could adversely affect the safe and sound operations of the regulated entity. The requirement reflects current practice in that the regulated entities generally obtain collateral to secure their swaps exposure to swap dealer counterparties, although current practice generally does not include posting of initial margin by or to any counterparty.
FHFA and FCA are proposing these provisions pursuant to each agency's role as safety and soundness regulator for its respective regulated entities, and each agency's authority to ensure that the regulated entities operate in a safe and sound manner, including that they maintain adequate capital and internal controls, that their activities foster liquid, efficient, competitive and resilient national finance markets for housing, agriculture, and rural markets, and that they carry out their public policy missions through authorized activities.[90]

Section __.11(a)(1) of the proposed rule requires a regulated entity to collect initial margin when it enters into a swap transaction with a swap entity. The proposal provides that the amount of initial margin the regulated entity must collect shall be in accordance with § __.3 of the proposed rule, which permits the use of either an initial margin model or the use of a standardized "look up" table specifying the minimum initial margin that must be collected as a percentage of the notional amount of the transaction. The minimum initial margin levels set out in Appendix A apply only in the absence of an initial margin model. FHFA and FCA, however, seek comment on whether a minimum initial margin requirement should apply as a backstop even to modeled initial margin amounts, as a prudent approach to address concerns about procyclicality and competitive pressures to reduce margin requirements. If not, how should such concerns be addressed?

Section __.11(a)(1) of the proposed rule permits a regulated entity to use its initial margin model to determine initial margin and provides that if the regulated entity does not have an initial margin model, it may engage a third party to calculate initial margin on its behalf, provided that the third party is itself independent of the swap entity that is the counterparty to the transaction. Any initial margin model used to determine margin posted to a regulated entity must meet all of the requirements of § __.8 of the proposed rule. FHFA and FCA preliminarily believe that permitting a swap entity to use its own model to calculate the amount of initial margin it would be required to post to a regulated entity may introduce a conflict of interest to the transaction. That concern could be addressed by establishing a process through which the regulated entity could verify the reasonableness of the counterparty's model calculation. FHFA and FCA each seeks comment on whether it should allow its regulated entities to use the counterparty's model to calculate initial margin, and if so, what provisions should be included to mitigate conflicts of interest.

Section __.11(a)(2) of the proposed rule requires that a regulated entity collect variation margin daily from the swap entity in accordance with the requirements of § __.4 of the proposed rule, which permits the amounts of variation margin posted to be adjusted to account for qualifying master netting agreements and applies a minimum transfer amount of $100,000.

Section __.11(b) of the proposed rule requires that any regulated entity entering into a non-cleared swap or a non-cleared security-based swap with a swap entity must execute trading documentation with such counterparty in accordance with § __.5 of the proposed rule. Section __.11(c) of the proposed rule provides that any collateral that a regulated entity is required to collect as initial or variation margin must meet the eligible collateral requirements of § __.6 of the proposed rule. That section applies the same eligibility requirements to the regulated entities that are required of the swap entities.

Section __.11(d) of the proposed rule provides that a regulated entity must require that any initial margin it posts to a counterparty be held by an independent custodian. That provision is consistent with the requirement in § __.7 of the proposed rule that a covered swap entity require segregation with an independent custodian of any initial margin that it posts to another swap entity. Section __.11(d) of the proposed rule applies this segregation requirement to variation margin as well as initial margin and thereby reflects current practice of at least some of the regulated entities. FHFA and FCA seek comments on whether such a requirement should be applied to variation margin and if it is not applied, how the regulated entities would be protected in the event variation margin is posted to a swap entity that subsequently fails.

IV. Quantitative Impact of Margin Requirements

The proposed rule would apply the initial margin and variation margin requirements to non-cleared swaps and security-based swaps that are entered into by a covered swap entity after the effective date, which is proposed to be 180 days after publication of a final rule in the Federal Register. The proposed rule would not require an immediate or retroactive application of initial margin or variation margin for any derivative transaction entered into prior to the effective date of the final rule.

Because the requirements would not be applied retroactively, no new initial margin or variation margin requirements would be imposed on derivatives transactions entered into prior to the effective date until such time as those transactions are rolled-over or renewed. The only requirements that would apply to a pre-effective date covered derivative would be the initial margin and variation margin requirements to which the parties to the transaction had previously agreed to by contract.

The new requirements will have an impact on the costs of engaging in new swap transactions. In particular, the proposed rule sets out requirements for initial and variation margin that represent a significant change from current industry practice in many circumstances. Assessing the quantitative impact of the proposed requirements is particularly difficult in light of the wide ranging and as yet undetermined changes that are occurring to the derivatives market as a result of regulatory reform. Specifically there is significant uncertainty with respect to (i) which entities would be classified as swap entities; (ii) the extent to which existing derivatives would be rolled-over or renewed; and (iii) the extent to which derivatives currently traded on an over-the-counter basis will move to central clearing by a CCP. In addition, there are a number of specific and technical aspects of the proposed rule, such as number and composition of counterparties that would be classified as high-risk financial end users, low-risk financial end users, and nonfinancial end users, respectively, that are difficult to assess without a large amount of highly detailed data on the size of derivative positions as well as the underlying rationale for maintaining those positions. These and other complicating factors make it difficult to make precise statements about the quantitative impact of the margin rule specified under the proposed rule.

Accordingly, the Agencies request commenters to provide their own detailed quantitative impact analyses. The Agencies encourage commenters to include the following elements in their analyses categorized between swaps entities, high-risk financial end users, low-risk financial end users, and nonfinancial end users: (i) required initial margin if internal models were applied; (ii) required initial margin if the standardized chart in Appendix A were applied; (iii) required variation margin; (iv) the expected costs of, or additional liquidity required by, the initial margin and variation margin requirements; and (v) the potential benefits of the initial margin and variation margin requirements to covered swap entities, their counterparties, and financial stability. The analyses should also (i) address operational and other business related costs associated with implementing the proposed rule and (ii) take into consideration and disclose the expected effect of the likely clearing of certain derivative transactions through CCPs in the future.

In order to better understand the effect that broader clearing requirements will have on the impact of the proposed rules, the Agencies also request comment on the levels of covered derivatives, including the roll-over or renewal of prior derivatives that would become covered under the proposed rule, that can be expected over the following time horizons after the effective date: (i) 1 year, (ii) 3 years, and (iii) 5 years. To maximize the usefulness of such comments, the Agencies request that commenters break down such projections by covered derivatives that are likely to be cleared and uncleared, as well as by product class.

V. Request for Comments.

The Agencies are interested in receiving comments on all aspects of the proposed rule.

VI. Solicitation of Comments on Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Pub. L. 106-102, sec. 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the OCC, Board and FDIC to use plain language in all proposed and final rules published after January 1, 2000. The OCC, Board and FDIC invite your comments on how to make this proposal easier to understand. For example:

- Have we organized the material to suit your needs? If not, how could this material be better organized?
- Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?
- Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?
- What else could we do to make the regulation easier to understand?

VII. Administrative Law Matters.

A. Paperwork Reduction Act Analysis

Request for Comment on Proposed Information Collection

Certain provisions of the proposed rule contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA"), 44 U.S.C. 3501-3521. In accordance with the requirements of the PRA, the Agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The information collection requirements contained in this joint notice of proposed rulemaking have been submitted by the FDIC, OCC, and FHFA to OMB for approval under section 3506 of the PRA and § 1320.11 of OMB's implementing regulations (5 CFR part 1320). The Board reviewed the proposed rule under the authority delegated to the Board by OMB.

Comments are invited on:

(a) Whether the collections of information are necessary for the proper performance of the agencies' functions, including whether the information has practical utility;
(b) The accuracy of the estimates of the burden of the information collections, including the validity of the methodology and assumptions used;
(c) Ways to enhance the quality, utility, and clarity of the information to be collected;
(d) Ways to minimize the burden of the information collections on respondents, including through the use of automated collection techniques or other forms of information technology; and
(e) Estimates of capital or start up costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record. Commenters may submit comments on aspects of this notice that may affect disclosure requirements and burden estimates at the addresses listed in the ADDRESSES section of this Supplementary Information. A copy of the comments may also be submitted to the OMB desk officer for the agencies: By mail to U.S. Office of Management and Budget, 725 17th Street, NW, #10235, Washington, DC 20503 or by facsimile (202-395-5806).

Title of Information Collection: Margin and Capital Requirements for Certain Swap Entities.

Frequency of Response: Event-generated and annual.

Affected Public: The affected public of the FDIC, OCC, and Board is assigned generally in accordance with the entities covered by the scope and authority section of their respective proposed rule. The affected public of FHFA generally would be those third parties not regulated by a prudential regulator that request prior written approval of an initial margin model for use by a regulated entity.

FDIC: Any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System or FDIC-insured state-chartered savings association that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.

OCC: Any national bank, Federal savings association, or Federal branch or agency of a foreign bank that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.

Board: Any state member bank (as defined in 12 CFR 208.2(g)), bank holding company (as defined in 12

U.S.C. 1842), savings and loan holding company (as defined in 12 U.S.C. 1467a, (on or after the transfer established under Section 311 of the Dodd-Frank Act)12 U.S.C. 5411)), foreign banking organization (as defined in 12 CFR 211.21(o)), state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), or Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)) that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.

FHFA: With respect to any regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)), the proposed rule would not contain any collection of information pursuant to the PRA. However, the provisions in proposed § __.11(e) allowing a third party that is not subject to regulation by a prudential regulator to request prior written approval of an initial margin model for use by a regulated entity, would be a collection of information under the PRA.

Abstract: The notice sets forth proposed margin and capital requirements with respect to non-cleared swaps and non-cleared security-based swaps for covered swap entities. The information requirements in joint regulations proposed by the Agencies are found in §§ __.2(t)(3), _.2(t)(4), _.4(e)(2)(i), __5, __.6(d)(2)(i), __.8(c)(1), __.8(c)(2), __8(c)(3), __8(d)(3), __8(d)(8), __.8(d)(9), __.8(d)(10), __.8(d)(12), __.8(e)(1), __.8(f)(2), __.8(f)(3), __.8(f)(4), and __.8(g). Compliance with the information collections found in sections __.2(t)(3) and _.2(t)(4) would be mandatory for any covered swap entity wishing to take a qualifying master netting agreement into account for purposes of calculating initial margin or variation margin. Compliance with the information collections found in §§ __.4(e)(2)(i), __.5, and _.6(d)(2)(i) would be mandatory for all covered swap entities. Compliance with the information collections found in §§ __.8(c)(1), __.8(c)(2), __.8(c)(3), __.8(d)(3), __.8(d)(8), __.8(d)(9), __.8(d)(10), __.8(d)(12), __.8(e)(1), __.8(f)(2), __.8(f)(3), __.8(f)(4), and __.8(g) would be mandatory for all covered swap entities wishing to use an initial margin model to calculate initial margin requirements.

In addition, § __.11(e) of FHFA's proposed rule contains an information collection that would be for all third parties that are not subject to regulation by a prudential regulator and that request prior written approval of an initial margin model for use by an FHFA-regulated entity.

Section-by-Section Analysis

Section _.2 defines terms used in the proposed rule, including the definition of "qualifying master netting agreement" contained in § __2(t). Sections __.2(t)(3) and __.2(t)(4) provide that, with respect to a qualifying master netting agreement, a covered swap entity must (i) conduct sufficient legal review of the agreement to conclude with a well-founded basis that the agreement meets specified criteria and (ii) establish and maintain procedures for monitoring relevant changes in law. The term "qualifying master netting agreement" is used elsewhere in the proposed rule to specify instances in which a covered swap entity may (i) calculate variation margin on an aggregate basis across multiple swaps and security-based swaps and (ii) calculate initial margin requirements under an initial margin model on a portfolio basis.

Section _.4 requires that on and after the date on which a covered swap entity enters into a non-cleared swap or non-cleared security-based swap, the covered swap entity shall collect variation margin from the counterparty to such swap or security-based swap in specified amounts. Section __.4(e)(2)(i) requires that, in cases where a counterparty refuses to provide required variation margin, a covered swap entity demonstrated upon request to the satisfaction of the relevant Agency that it has made appropriate efforts to collect the required variation margin unless it has otherwise made the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms.

Section __.5 requires a covered swap entity to execute trading documentation with each counterparty that (i) includes credit support arrangements that grant the covered swap entity the contractual right to collect initial margin and variation margin in such amounts, in such form, and such circumstances as are required by the initial margin and variation margin requirements set forth in the proposed rule and (ii) meets other specified criteria.

Section __.6 establishes certain forms of eligible collateral that a covered swap entity shall collect for initial margin and variation margin required pursuant to this part and requires a covered swap entity to monitor the market value of any eligible collateral it has collected to satisfy initial margin or variation margin required by this part and, to the extent that the market value of such collateral has declined, collect such additional eligible collateral as is necessary to bring itself into compliance with the margin requirements of this part. Section __.6(d)(2)(i) requires that, in cases where a counterparty refuses to provide required additional margin, a covered swap entity demonstrated upon request to the satisfaction of the relevant Agency that it has made appropriate efforts to collect the required additional margin unless it has otherwise made the necessary efforts to attempt to collect the required additional margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms.

Section __.8 establishes standards for initial margin models. These standards include:

- requirement that the covered swap entity receive prior approval from the relevant Agency based on demonstration that the initial margin model meets specific requirements (§§ __.8(c)(1) and __.8(c)(2)); · A requirement that a covered swap entity notify the relevant Agency in writing before extending use of the model to additional product types, making certain changes to the initial margin model, or making material changes to modeling assumptions (§ __.8(c)(3));
- A variety of quantitative requirements, including requirements that the covered swap entity validate and demonstrate the reasonableness of its process for modeling and measuring hedging benefits, demonstrate to the satisfaction of the relevant Agency that the omission of any risk factor from the calculation of its initial margin is appropriate, demonstrate to the satisfaction of the relevant Agency that any conversion of initial margin calculated using a different holding period is appropriate, periodically review and, as necessary, revise the data used to calibrate the initial margin model to ensure that the data incorporate an appropriate period of significant financial stress (§§ __.8(d)(3), __.8(d)(8), __.8(d)(9), __.8(d)10), __.8(d)(12));
- A requirement that a covered swap entity review its initial margin model annually (§ __.8(e));
- A requirement that the covered swap entity validate its initial margin model initially and on an ongoing basis, describe to the relevant Agency any remedial actions being taken, and report internal audit findings regarding the effectiveness of the initial margin model to the covered swap entity's board of directors or a committee thereof (§§ __.8(f)(2), __.8(f)(3), and __.8(f)(4)); and
- A requirement that the covered swap entity adequately document all material aspects of its initial margin model (§ __.8(g)).

Section __.11(e) of FHFA's proposed rule applies § __.8 of the proposed rule, the information collection of which is described above, to any third party that is not subject to regulation by a prudential regulator and requests prior written approval of an initial margin model for use by an FHFA-regulated entity.

<u>Estimated Paperwork Burden</u>

Estimated Burden Per Response:

§ __.2 – Definitions, § __.5 – Documentation of margin matters, and § __.8(g) –Documentation: recordkeeping – 5 hours.

§ __.4(e)(2)(i) – Variation margin and § __.6(d)(2)(i) – Eligible collateral: recordkeeping -- 4 hours.

§ __.8(c) and (d) – Initial margin model: reporting – 240 hours.

§ __.8(e) -- Periodic review and § __.8 (f) – Control, oversight and validation mechanisms: recordkeeping – 40 hours.

§ __.11(e) – Special requirements for transactions between swap entities and regulated entities: Initial margin models: recordkeeping – 220 hours.

FDIC

Number of Respondents: 3.

Total Estimated Annual Burden: 867 hours.

OCC

Number of Respondents: 20.

Total Estimated Annual Burden: 5,780 hours.

Board

Number of Respondents: 30.

Total Estimated Annual Burden: 8,670 hours.

FHFA

Number of Respondents: 2.

Total Estimated Annual Burden: 440 hours.

FCA: The FCA collects information from Farm Credit System institutions, which are Federal instrumentalities, in the FCA's capacity as their safety and soundness regulator, and, therefore, OMB approval is not required for this collection.

B. Initial Regulatory Flexibility Act Analysis

In accordance with section 3(a) of the Regulatory Flexibility Act, 5 U.S.C. 601 et. seq. (RFA), the Agencies are publishing an initial regulatory flexibility analysis for the proposed rule. The RFA requires an agency to provide an initial regulatory flexibility analysis with the proposed rule or to certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. The Agencies welcome comment on all aspects of the initial regulatory flexibility analysis. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period.

1. Statement of the objectives of the proposal. As required by section 4s of the Commodity Exchange Act (7 U.S.C. 6(s)) and section 15F of the Securities Exchange Act (15 U.S.C. 78o-8), the Agencies are proposing new regulations to establish rules imposing (i) capital requirements and (ii) initial and variation margin requirements on all non-cleared swaps into which the covered swap entities enter.

2. Small entities affected by the proposal. This proposal may have an effect predominantly on two types of small entities: (i) financial institutions that are swap entities that are subject to the proposed rule's capital and margin requirements; and (ii) counterparties that engage in derivatives transactions with swap entities that are subject to the proposed rule's margin requirements.

With respect to financial institutions that are swap entities that are subject to the proposed rule's margin requirement, a financial institution generally is considered small if it has assets of $175 million or less.[91] Based on 2010 Call Report data, approximately 4,200 depository institutions had total domestic assets of $175 million or less. Of this number, however, the Agencies do not expect that any is likely to be a swap entity that is subject to the proposed rule's capital and margin requirements. With respect to counterparties that engage in derivatives transactions with swap entities that are subject to the proposed rule's margin requirements, the number of such counterparties and the extent to which certain types of companies are likely to be counterparties are unknown. However, of the 4,200 depository institutions described above, fewer than 250 are party to non-cleared derivative contracts.

3. Compliance requirements. With respect to the initial margin and variation margin requirements, the Agencies' proposed rule does not apply directly to counterparties that engage in derivatives transactions with swap entities. However, because the proposed rule requires a covered swap entity to collect a minimum amount of margin (subject to a threshold in some cases) from all counterparties, including small entities, the margin requirements may affect the amount of margin that counterparties that are small entities are required to post to dealer counterparties when transacting in the derivatives markets. Accordingly, the Agencies expect any economic impact on counterparties that are small entities to be negative to the extent that swap entities currently do not collect initial margin or variation margin from those counterparties but would be required to do so under the proposed rule.

4. Other Federal rules. The Agencies believe that no Federal rules duplicate, overlap, or conflict with the proposed rule.

5. Significant alternatives to the proposed rule. As discussed above, the Agencies have requested comment on the impact of the margin requirements on end users from which swap entities may be required to collect initial margin and/or variation margin and have solicited comment on any approaches that would reduce the burden on all counterparties, including small entities. In addition, the Agencies have proposed to reduce the effect of the proposed rule on counterparties to covered swap entities, including small entities, through the implementation of initial margin threshold amounts and variation margin threshold amounts. The Agencies have also requested comment on a variety of alternative approaches to implementing margin requirements with respect to swaps and security-based swaps with counterparties that are end users. The Agencies welcome comment on any significant alternatives that would minimize the impact of the proposal on small entities.

<u>FCA</u>: Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 601 <u>et</u> <u>seq</u>., FCA

hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities; nor does the Federal Agricultural Mortgage Corporation meet the definition of "small entity." Therefore, System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

FHFA: FHFA believes that the proposed rule, if promulgated as a final rule, would not have a significant economic impact on a substantial number of small entities, since none of FHFA's regulated entities come within the meaning of small entities as defined in the Regulatory Flexibility Act (see 5 U.S.C. 601(6)), and would not substantially affect any business that its regulated entities might do with small entities.

C. OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Public L. 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million (adjusted for inflation) or more in any one year. The current inflation-adjusted expenditure threshold is $126.4 million. If a budgetary impact statement is required, section 205 of the UMRA also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million (adjusted for inflation) or more in any one year. The current inflation-adjusted expenditure threshold is $126.4 million. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

The OCC has determined this proposed rule is likely to result in the expenditure by the private sector of $126.4 million or more. Therefore, the OCC has prepared a budgetary impact analysis and identified and considered alternative approaches. The full text of the OCC's analyses under the Unfunded Mandates Act is available at: http://www.regulations.gov, Docket ID OCC-2011-0008.

Text of the Proposed Common Rules

(All Agencies)

The text of the proposed common rules appears below:

PART [ ]— MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

____.1 Authority, purpose, and scope
____.2 Definitions
____.3 Initial margin
____.4 Variation margin

§ __.1 Authority, purpose, and scope.

[Reserved]

§ __.2 Definitions.

(a) Clearing agency has the meaning specified in section 3(a)(23) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(23)).

(b) Counterparty means, with respect to any swap or security-based swap to which a covered swap entity is a party, the counterparty to such swap or security-based swap, other than a counterparty that is a derivatives clearing organization or clearing agency.

(c) [Reserved]

(d) Derivatives clearing organization has the meaning specified in section 1a(15) of the Commodity Exchange Act (7 U.S.C. 1a(15)).

(e) Eligible collateral means collateral described in § __.6.

(f) Effective date means **[date that is 180 days after publication of the final rule in the Federal Register]**.

(g) End user means a counterparty that is not a swap entity.

(h) Financial end user means any counterparty that is an end user that is—

(1) A commodity pool as defined in section 1a(5) of the Commodity Exchange Act (7 U.S.C. 1a(5));

(2) A private fund as defined in section 202(a) of the Investment Advisors Act of 1940 (15 U.S.C. 80-b-2(a));

(3) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002);

(4) A person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company of 1956 (12 U.S.C. 1843(k));

(5) A person that would be a financial end user described in paragraph (h)(1) or (h)(2) of this section, if it were organized under the laws of the United States or any State thereof;

(6) A government of any foreign country or a political subdivision, agency, or instrumentality thereof; or

(7) Any other person that [Agency] may designate.

(i) High-risk financial end user means a counterparty that is a financial end user but is not a low-risk financial end user.

(j) Initial margin means eligible collateral that is pledged in connection with entering into a swap or security-based swap by a party thereto to secure the performance of its obligations to its counterparty under one or more swaps or security-based swaps.

(k) Initial margin collection amount means—

(1) In the case of a covered swap entity that does not have an initial margin model, the amount of initial margin with respect to a swap or security-based swap that is required under Appendix A of this part; and

(2) In the case of a covered swap entity that does have an initial margin model, the amount of initial margin with respect to a swap or security-based swap that is required under the initial margin model.

(l) Initial margin model means an internal risk management model that–

(1) Has been developed and designed to identify an appropriate, risk-based amount of initial margin that the covered swap entity must collect with respect to one or more swaps or security-based swaps to which the covered swap entity is a party; and

(2) Has been approved by [Agency] pursuant to § __.8 of this part.

(m) Initial margin threshold amount means a credit exposure limit that has been established by a covered swap entity with respect to its swaps and security-based swaps with a counterparty, that appropriately takes into account and addresses the credit risk posed by the counterparty and the risks of such swaps and security-based swaps, and that has been reviewed, monitored and approved in accordance with the covered swap entity's credit processes, except that in no case shall the threshold amount be greater than—

(1) Zero, if the counterparty is either a swap entity or a high-risk financial end user; or

(2) The lesser of **[**$15 to $45**]** million and **[**0.1 to 0.3**]** percent of the covered swap entity's [capital metric], if the counterparty is a low-risk financial end user.

(n) Low-risk financial end user means a counterparty that is a financial end user and makes the following representations to a covered swap entity in connection with entering into a swap or security-based swap with the covered swap entity—

(1) The counterparty does not have a significant swaps exposure;

(2) The counterparty predominantly uses swaps or security-based swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate, or other risk arising from the business of the counterparty; and

(3) The counterparty is subject to capital requirements established by a prudential regulator or state insurance regulator.

(o) Margin means initial margin and variation margin.

(p) Non-cleared swap means a swap that is not a cleared swap, as that term is defined in section 1a(7) of the Commodity Exchange Act (7 U.S.C. 1a(7)).

(q) Non-cleared security-based swap means a security-based swap that is not, directly or indirectly, submitted to and cleared by a clearing agency registered with the SEC.

(r) Nonfinancial end user means any counterparty that is an end user but is not a financial end user.

(s) Prudential regulator has the meaning specified in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a(39)).

(t) Qualifying master netting agreement means an agreement governing one or more swaps or security-based swaps to which a covered swap entity is a party that satisfies the following criteria—

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including bankruptcy, insolvency, or similar proceeding, of the counterparty;

(2) The agreement provides the covered swap entity the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of bankruptcy, insolvency, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions;

(3) The covered swap entity has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that—

(i) The agreement meets the requirements of paragraph (t)(2) of this definition; and

(ii) In the event of a legal challenge (including one resulting from default or from bankruptcy, insolvency, or similar proceeding) the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions;

(4) The covered swap entity establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of this definition; and

(5) The agreement does not contain a provision that permits a non-defaulting counterparty to make a lower payment than it would make otherwise under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement.

(u) Security-based swap has the meaning specified in section 3(a)(68) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)).

(v) Significant swaps exposure means—

(1) Swap positions that equal or exceed any of the following thresholds—

(i) $2.5 billion in daily average aggregate uncollateralized outward exposure; or

(ii) $4 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure; or

(2) Security-based swap positions that equal or exceed any of the following thresholds—

(i) $1 billion in daily average aggregate uncollateralized outward exposure; or

(ii) $2 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure.

(3) For purposes of this definition—

(i) The terms daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure, when used with respect to swaps, each has the meaning specified for that term in **[**17 CFR 1.3(uuu)**]** for purposes of calculating substantial counterparty exposure under that regulation.

(ii) The terms daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure, when used with respect to security-based swaps, each has the meaning specified for that term in **[**15 CFR 240.3a67-5**]** for purposes of calculating substantial counterparty exposure under that regulation.

(w) State insurance regulator means an insurance authority of a State that is engaged in the supervision of insurance companies under State insurance law.

(x) Swap has the meaning specified in section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)).

(y) Swap entity means a security-based swap dealer as defined in section 3(a)(71) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(71)), a major security-based swap participant as defined in section 3(a)(67) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(67)), a swap dealer as defined in section 1a(49) of the Commodity Exchange Act (7 U.S.C. 1a(49)), or a major swap participant as defined in section 1a(33) of the Commodity Exchange Act (7 U.S.C. 1a(33)) .

(z) Variation margin means eligible collateral pledged or paid on an intraday, daily or other periodic basis by one party to a swap or security-based swap to its counterparty to offset a change in the value of one or more swaps or security-based swaps between the parties, as calculated in accordance with the contractual terms of such swaps or security-based swaps.

(aa) Variation margin amount means the cumulative mark-to-market change in value to a covered swap entity of a swap or security-based swap, as measured from the date it is entered into (or, in the case of swap or security-based swap that has a current positive or negative value to a covered swap entity on the date it is entered into, such positive or negative value plus any cumulative mark-to-market change in value to the covered swap entity of a swap or security-based swap after such date), less the value of all variation margin previously collected but not returned by the covered swap entity (expressed as a positive amount) with respect to such swap or security-based swap.

(bb) Variation margin threshold amount means a credit exposure limit that has been established by a covered swap entity with respect to its swaps and security-based swaps with a counterparty, that appropriately takes into account and addresses the credit risk posed by the counterparty and the risks of such swaps and security-based swaps, and that has been reviewed, monitored and approved in accordance with the covered swap entity's credit processes, except that in no case shall the threshold amount be greater than—

(1) Zero, if the counterparty is a either a swap entity or a high-risk financial end user; or

(2) The lesser of **[**$15 to 45**]** million and **[**0.1 to 0.3**]**% of the covered swap entity's [capital metric], if the counterparty is a low-risk financial end user.

§ __.3 Initial margin.

(a) General. A covered swap entity shall collect initial margin with respect to any non-cleared swap or non-cleared security-based swap from the counterparty to such swap or security-based swap in an amount that is no less than the greater of—

(1) Zero; or

(2) The initial margin collection amount for such swap or security-based swap less the initial margin threshold amount for the counterparty (not including any portion of the initial margin threshold amount being applied to other swaps or security-based swaps with the counterparty), as applicable.

(b) Timing. A covered swap entity shall, with respect to any non-cleared swap or non-cleared security-based swap to which it is a party, comply with the initial margin requirements described in paragraph (a) for a period beginning on or before the date it enters into such swap or security-based swap and ending on the date the non-cleared swap or non-cleared security-based swap is terminated or expires.

(c) Minimum Transfer Amount. Notwithstanding anything else in this section, a covered swap entity is not required to collect initial margin pursuant to this section with respect to a particular counterparty unless and until the total amount of initial margin that is required pursuant to this section to be collected, but has not yet been collected, with respect to the counterparty is greater than $100,000.

§ __.4 Variation margin.

(a) General. On and after the date on which a covered swap entity enters into a non-cleared swap or non-cleared security-based swap, the covered swap entity shall, to the extent the variation margin amount for such swap or security-based swap is positive, collect variation margin from the counterparty to such swap or security-based swap in an amount that is no less than the greater of—

(1) Zero; or

(2) The variation margin amount for such swap or security-based swap less the variation margin threshold amount for the counterparty (not including any portion of the variation margin threshold amount being applied to other swaps or security-based swaps with the counterparty), as applicable.

(b) Frequency. A covered swap entity shall comply with the variation margin requirements described in paragraph (a) of this section—

(1) No less than once per business day with respect to a counterparty that is a swap entity or a financial end user; and

(2) No less than once per week with respect to a counterparty that is a nonfinancial end user.

(c) Minimum Transfer Amount. Notwithstanding anything else in this section, a covered swap entity is not required to collect variation margin pursuant to this section unless and until the total amount of variation margin that is required pursuant to this section to be collected, but has not yet been collected, with respect to the counterparty is greater than $100,000.

(d) Netting Arrangements. To the extent that one or more non-cleared swaps or non-cleared security-based swaps are executed pursuant to a qualifying master netting agreement between a covered swap entity and its counterparty, a covered swap entity may calculate and comply with the variation margin requirements of this paragraph on an aggregate basis with respect to all swaps and security-based swaps governed by such agreement, so long as the covered swap entity complies with these variation margin requirements with respect to all swaps and security-based swaps governed by such agreement regardless of whether the swaps and security-based swaps were entered into on or after the effective date.

(e) A covered swap entity shall not be deemed to have violated its obligation under paragraph (a) of this section to collect variation margin from a counterparty if—

(1) The counterparty has refused or otherwise failed to provide the required variation margin to the covered swap entity; and

(2) The covered swap entity has—

(i) Made the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction of [Agency] that it has made appropriate efforts to collect the required variation margin; or

(ii) Commenced termination of the swap or security-based swap with the counterparty.

§ __.5 Documentation of margin matters.

A covered swap entity shall execute trading documentation with each counterparty regarding credit support arrangements that—

(a) Provides the covered swap entity with the contractual right to collect initial margin and variation margin in such amounts, in such form, and under such circumstances as are required by this part; and

(b) Specifies—

(1) The methods, procedures, rules, and inputs for determining the value of each swap or security-based swap for purposes of calculating variation margin requirements; and

(2) The procedures by which any disputes concerning the valuation of swaps or security-based swaps, or the valuation of assets collected or posted as initial margin or variation margin, may be resolved.

§ __.6 Eligible collateral.

(a) A covered swap entity shall collect initial margin and variation margin required pursuant to this part solely in the form of one or more of the following types of eligible collateral—

(1) Immediately available cash funds that are denominated in—

(i) U.S. dollars; or

(ii) The currency in which payment obligations under the swap are required to be settled;

(2) Any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, the United States; and

(3) With respect to initial margin only—

(i) Any senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks and the Federal Agricultural Mortgage Corporation; and

(ii) Any obligation that is an "insured obligation," as that term is defined in 12 U.S.C. 2277a(3), of a Farm Credit System bank.

(b) The value of any eligible collateral described in paragraphs (a)(2) or (a)(3) of this section, for purposes of satisfying the initial margin or variation margin requirements of this part shall be subject to, and limited by, the discounts described in Appendix B of this part.

(c) A covered swap entity may not collect, as initial margin or variation margin required by this part, any collateral that is an obligation of the counterparty pledging such collateral.

(d) A covered swap entity shall monitor the market value of any eligible collateral it has collected to satisfy initial margin or variation margin required by this part and, to the extent that the market value of such collateral has declined, shall collect such additional eligible collateral as is necessary to bring itself into compliance with the margin requirements of this part. A covered swap entity shall not be deemed to have violated its obligation under this paragraph (d) to collect additional eligible collateral from a counterparty if—

(1) The counterparty has refused or otherwise failed to provide the required additional eligible

collateral to the covered swap entity; and

(2) The covered swap entity—

(i) Has made the necessary efforts to attempt to collect the required additional eligible collateral, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction of [Agency] that it has made appropriate efforts to collect the required additional eligible collateral; or

(ii) Has commenced termination of the swap or security-based swap with the counterparty.

(e) A covered swap entity may collect initial margin and variation margin that is not required pursuant to this part in any form of collateral.

§ __.7 Segregation of collateral.

A covered swap entity that enters into a non-cleared swap or non-cleared security-based swap with a swap entity and posts initial margin to the swap entity with respect to that swap or security-based swap shall require that—

(a) All funds or other property the covered swap entity provides as initial margin are held by a third-party custodian that is independent of the covered swap entity and the counterparty;

(b) The independent custodian is prohibited by contract from rehypothecating or otherwise transferring any initial margin held by the custodian;

(c) The independent custodian is prohibited by contract from reinvesting any initial margin held by the custodian in any asset that would not qualify as eligible collateral under § __.6 for purposes of satisfying the initial margin requirements of this part; and

(d) The independent custodian is located in a jurisdiction that applies the same insolvency regime to the independent custodian as would apply to the covered swap entity.

§ __.8 Initial margin models.

(a) General adequacy of initial margin model. Unless a covered swap entity's initial margin model conforms to the requirements of this section, the covered swap entity shall calculate all initial margin collection amounts pursuant to Appendix A of this part.

(b) Applicability to swaps and security-based swaps. Any initial margin model that a covered swap entity wishes to use to calculate the amount of initial margin required to be collected for a single swap or security-based swap transaction or a portfolio of swap and/or security-based swap transactions with a given counterparty pursuant to § __.3 must meet each requirement of this section. An initial margin model may be designed to calculate initial margin for a portfolio of swaps and/or security-based swaps only if all such swaps and/or security-based swaps are governed by the same qualifying master netting agreement. To the extent that a qualifying master netting agreement between a covered swap entity and its counterparty governs swaps or security-based swaps that were entered into before, on, and after the effective date, the covered swap entity may use its initial margin model to calculate the amount of initial margin required to be collected pursuant to § __.3 either—

(1) With respect to only those swaps and/or security-based swaps transactions entered into on and after the effective date; or

(2) With respect to all swaps and/or security-based swaps transactions governed by such qualifying master netting agreement, regardless of whether they were entered into before, on, or after the effective date.

(c) Requirements for initial margin model.

(1) A covered swap entity must obtain the prior written approval of [Agency] before using any initial margin model to calculate the initial margin required in this part.

(2) A covered swap entity must demonstrate that the initial margin model satisfies all of the requirements of this section on an ongoing basis.

(3) A covered swap entity must promptly notify [Agency] in writing prior to:

(i) Extending the use of an initial margin model that [Agency] has approved under this section to an additional product type;

(ii) Making any change to any initial margin model approved by [Agency] under this section that would result in a material change in the covered swap entity's assessment of initial margin requirements; or

(iii) Making any material change to modeling assumptions used by the initial margin model.

(4) [The Agency] may rescind its approval of the use of any initial margin model, in whole or in part, or may impose additional conditions or requirements if [Agency] determines that the initial margin model no longer complies with this section.

(d) Quantitative Requirements.

(1) The covered entity's initial margin model must calculate an amount of initial margin that is equal to the potential future exposure of the swap, security based swap or portfolio of swaps and/or security-based swaps. Potential future exposure is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the swap, security-based swap or portfolio of swaps and/or security-based swaps due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including prices, rates, and spreads, over a holding period equal to the shorter of ten business days or the maturity of the swap or security-based swap. If a covered swap entity elects to calculate initial margin using an initial margin model on a portfolio of swaps and/or security-based swaps under the same qualifying master netting agreement, the covered entity must calculate an amount of initial margin for that portfolio each time a new swap or security-based swap is added to that portfolio and collect any incremental initial margin collection amount that is required.

(2) The covered swap entity's initial margin model must use risk factors sufficient to measure all material price risks inherent in the swap transactions for which initial margin is being calculated. The risk categories must include, but should not be limited to, foreign exchange/interest rate risk, credit risk, equity risk, and commodity risk, as appropriate. For material exposures in the major currencies and markets, modeling techniques must capture spread and basis risk and must incorporate a sufficient number of segments of the yield curve to capture differences in volatility and imperfect correlation of rates along the yield curve.

(3) The initial margin model may calculate initial margin for a portfolio of swaps and/or security-based swaps and reflect offsetting exposures, diversification, and other hedging benefits for swaps and security-based swaps that are governed by the same qualifying master netting agreement by incorporating empirical correlations within the following four broad risk categories, provided the covered swap entity validates and demonstrates the reasonableness of its process for modeling and measuring hedging benefits: commodity, credit, equity, and foreign exchange/interest rate. Offsetting exposures, diversification, and other hedging benefits under a qualifying master netting agreement may be recognized by the initial margin model within each broad risk category, but not across broad risk categories.

(4) If the initial margin model does not explicitly reflect offsetting exposures, diversification, and hedging benefits within a broad risk category, the covered swap entity must calculate an amount of initial margin separately for each subset of swaps and security-based swaps for which offsetting exposures, diversification, and other hedging benefits are explicitly recognized by the initial margin model. The sum of the initial margin amounts calculated for each subset of swaps and security-based swaps within a broad risk category will be used to determine the aggregate initial margin due from the counterparty for the portfolio of swaps and security-based swaps within the broad risk category.

(5) The sum of the initial margins calculated for each broad risk category will be used to determine the aggregate initial margin due from the counterparty.

(6) The initial margin model may not permit the calculation of any initial margin collection amount to be subject to offset by, or otherwise take into account, any initial margin that may be owed or otherwise payable by the covered swap entity to the counterparty.

(7) The initial margin model must include all material risks arising from the nonlinear price characteristics of options positions or positions with embedded optionality and the sensitivity of the

market value of the positions to changes in the volatility of the underlying rates, prices, or other material risk factors. As an example, a covered swap entity with a large or complex options portfolio must measure the volatility of options positions or positions with embedded optionality by different maturities and/or strike prices, where material.

(8) The covered swap entity may not omit any risk factor from the calculation of its initial margin that the covered swap entity uses in its initial margin model unless it has previously demonstrated to the satisfaction of [Agency] that such omission is appropriate.

(9) The covered swap entity may not incorporate any proxy or approximation used to capture the risks of the covered swap entity's actual swap or security-based swap transactions unless it has previously demonstrated to the satisfaction of [Agency] that such proxy or approximation is appropriate.

(10) The covered swap entity may calculate initial margin over the holding period directly or it may convert an initial margin calculated using a different holding period. A covered swap entity may not convert its initial margin calculation in such a manner unless it has previously demonstrated to the satisfaction of [Agency] that such conversion is appropriate.

(11) All data used to calibrate the initial margin model must be based on a historical observation period of at least one year and must incorporate a period of significant financial stress appropriate to the swap and/or security-based swap transactions to which the initial margin model is applied.

(12) The covered swap entity must review and, as necessary, revise the data used to calibrate the initial margin model at least monthly, and more frequently as market conditions warrant, to ensure that the data incorporate a period of significant financial stress appropriate to the swap and/or security-based swap transactions to which the initial margin model is applied.

(13) The level of sophistication of the initial margin model must be commensurate with the complexity of the swap and/or security-based swap transactions to which they are applied. In calculating an initial margin collection amount, the initial margin model may make use of any of the generally accepted approaches for modeling the risk of a single instrument or portfolio of instruments.

(14) The covered swap entity must periodically benchmark the initial margin model against observable margin standards to ensure that the initial margin required is not less than what a derivatives clearing organization or a clearing agency would require for similar transactions.

(15) [The Agency] may require a covered swap entity using an initial margin model to collect a greater amount of initial margin than that determined by the covered swap entity's initial margin model.

(e) <u>Periodic review</u>. A covered swap entity must periodically, but no less frequently than annually, review its initial margin model in light of developments in financial markets and modeling technologies, and enhance the initial margin model as appropriate to ensure that the initial margin model continues to meet the requirements for approval in this section.

(f) <u>Control, oversight, and validation mechanisms</u>.

(1) The covered swap entity must have a risk control unit that reports directly to senior management and is independent from the business trading units.

(2) The covered swap entity must validate its initial margin model initially and on an ongoing basis. The covered swap entity's validation process must be independent of the development, implementation, and operation of the initial margin model, or the validation process must be subjected to an independent review of its adequacy and effectiveness. The validation process must include:

(i) An evaluation of the conceptual soundness of (including developmental evidence supporting) the initial margin model;

(i) An ongoing monitoring process that includes verification of processes and benchmarking by comparing the covered swap entity's initial margin model outputs (estimation of initial margin) with relevant alternative internal and external data sources or estimation techniques; and

(ii) An outcomes analysis process that includes backtesting of the initial margin model.

(3) If the validation process reveals any significant problems with the initial margin model, the covered swap entity must notify [Agency] of the problems, describe to [Agency] any remedial actions

being taken, and adjust the initial margin model to insure an appropriately conservative amount of required initial margin is being calculated.

(4) The covered swap entity must have an internal audit function independent of business-line management that at least annually assesses the effectiveness of the controls supporting the covered swap entity's initial margin model measurement systems, including the activities of the business trading units and independent risk control unit, compliance with policies and procedures, and calculation of the covered swap entity's initial margin requirements under this part. At least annually, the internal audit function must report its findings to the covered swap entity's board of directors or a committee thereof.

(g) Documentation. The covered swap entity must adequately document all material aspects of its initial margin model, including management and valuation of swap and/or security-based swap transactions to which they apply, the control, oversight, and validation of the initial margin model, any review processes and the results of such processes.

§ __.9 Application of margin requirements to certain foreign covered swap entities.

(a) The requirements of §§ __.3 through __.8 shall not apply to any foreign non-cleared swap or foreign non-cleared security-based swap of a foreign covered swap entity.

(b) For purposes of this section, a foreign non-cleared swap or foreign non-cleared security-based swap is any non-cleared swap or non-cleared security-based swap transaction with respect to which–

(1) The counterparty to the foreign covered swap entity is–

(i) Not an entity organized under the laws of the United States or any State;

(ii) Not a branch or office of an entity organized under the laws of the United States or any State; and

(iii) Not a person resident in the United States; and

(2) Performance of the counterparty's obligations to the foreign covered swap entity under the swap or security-based swap has not been guaranteed by an affiliate of the counterparty that is–

(i) An entity organized under the laws of the United States or any State;

(ii) A branch or office of an entity organized under the laws of the United States or any State; or

(iii) A person resident in the United States.

(c) For purposes of this section, a foreign covered swap entity is any covered swap entity that is–

(1) Not a company organized under the laws of the United States or any State;

(2) Not a branch or office of a company organized under the laws of the United States or any State;

(3) Not a U.S. branch, agency or subsidiary of a foreign bank; and

(4) Not controlled, directly or indirectly, by a company that is organized under the laws of the United States or any State.

§ __.10 Capital.

[Reserved]

Appendix A to Part [ ] -- Standardized minimum initial margin requirements for non-cleared swaps and non-cleared security-based swaps.

Standardized Minimum Initial Margin Requirements for Non-cleared Swaps and Non-cleared Security-Based Swaps	

Asset Class	Initial Margin Requirement (% of Notional Exposure)
Credit: 0-2 year duration	[1-3]
Credit: 2-5 year duration	[2-8]
Credit: 5+ year duration	[5-15]
Commodity	[10-20]
Equity	[10-20]
Foreign Exchange/Currency	[3-9]
Interest Rate: 0-2 year duration	[0-2]
Interest Rate: 2-5 year duration	[1-3]
Interest rate: 5+ year duration	[2-6]
Other	[10-20]

Appendix B to Part [ ] -- Margin values for noncash collateral.

Margin Values for Noncash Collateral			
	Margin Value (% of Market Valu Duration (Years)		
	0-5	5-10	
U.S. Treasuries and Fully Guaranteed Agencies			
Bills/Notes/Bonds/Inflation Indexed	[98-100]	[95-99]	
Zero Coupon, STRIPs	[97-99]	[94-98]	
Senior Debt Obligations of FHFA Regulated Entities and the Federal Agricultural Mortgage Corporation, and Insured Obligations of Farm Credit System Banks			
Bills/Notes/Bonds	[96-100]	[94-98]	
Zero Coupon	[95-99]	[93-97]	

[END OF COMMON TEXT]

Adoption of the Common Rule Text

The proposed adoption of the common rules by the agencies, as modified by agency-specific text, is set forth below:

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Chapter I

List of Subjects
12 CFR Part 45

Administrative practice and procedure, Capital, Margin requirements, National banks, Reporting and recordkeeping requirements, Risk.

Authority and Issuance

For the reasons stated in the Common Preamble, the Office of the Comptroller of the Currency proposes to amend chapter I of Title 12, Code of Federal Regulations as follows:

PART45 –MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

1. The authority citation for part 45 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 12 U.S.C. 1 et seq., 93a, 161, 1818, 3907, 3090, and 15 U.S.C. 78o-10(e).

2. Part 45 is added as set forth at the end of the Common Preamble.

3. Part 45 is amended by:
a. Removing "[Agency]" wherever it appears and adding in its place "the OCC";
b. Removing "[The Agency]" wherever it appears and adding in its place "The OCC"; and
c. Removing "[capital metric]" wherever it appears and adding in its place "Tier 1 capital".

4. Section 45.1 is added to read as follows:

§ 45.1 Authority, purpose, and scope.

(a) Authority. This part is issued under the authority of 7 U.S.C. 6s(e), 12 U.S.C. 1 et seq., 93a, 161, 1818, 3907, 3090, and 15 U.S.C. 78o-10(e).

(b) Purpose. Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o-8) require the OCC to establish capital and margin requirements for any national bank, Federal savings association, or Federal branch or agency of a foreign banks that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statutes' requirements.

(c) Scope. This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after **[insert date that is 180 days after publication of the final rule in the Federal Register**]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

5. Paragraph (c) of § 45.2 is added to read as follows:

§ 45.2 Definitions.

* * * * *

(c) Covered swap entity means any national bank, Federal savings association, or Federal branch and agency of a foreign bank that is a swap entity, or any other entity that the OCC determines.

* * * * *

6. Section 45.10 is added to read as follows:

§ 45.10 Capital.

A covered swap entity shall comply with:

(a) In the case of a covered swap entity that is a national bank, the minimum capital requirements in 12 CFR part 3;

(b) In the case of a covered swap entity that is a Federal savings association, the minimum capital requirements in 12 CFR part 567; and

(c) In the case of a covered swap entity that is a Federal branch or agency of a foreign bank, the capital adequacy guidelines that are applicable as generally provided under 12 CFR 28.14.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
12 CFR Chapter II

List of Subjects
12 CFR Part 237

Administrative practice and procedure, Banks and banking, Capital, Foreign banking, Holding companies, Margin requirements, Reporting and recordkeeping requirements, Risk.

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Board of Governors of the Federal Reserve System proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 237 to 12 CFR Chapter II as follows:

PART 237 —MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES (REGULATION KK)

7. The authority citation for part 237 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o-10(e), 12 U.S.C. 221 et seq., 12 U.S.C. 1818, 12 U.S.C. 1841 et seq., and 12 U.S.C. 3103 et seq..

8. Part 237 is added as set forth at the end of the Common Preamble.

9. Part 237 is amended by:

a. Removing "[Agency]" wherever it appears and adding in its place "the Board";

b. Removing "[The Agency]" wherever it appears and adding in its place "The Board"; and

c. Removing "[capital metric]" wherever it appears and adding in its place "tier 1 capital".

10. Section 237.1 is added to read as follows:

§ 237.1 Authority, purpose, and scope.

(a) Authority. This part (Regulation KK) is issued by the Board of Governors of the Federal Reserve System ((Board) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)) and section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)), as well as under the Federal Reserve Act, as amended (12 U.S.C. 221 et seq.); section 8 of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1818); the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.); and the International Banking Act of 1978, as amended (12 U.S.C. 3101 et seq.).

(b) Purpose. Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o-8) require the Board to establish capital and margin requirements for any state member bank (as defined in 12 CFR 208.2(g)), bank holding company (as defined in 12 U.S.C. 1842), savings and loan holding company (as defined in 12 U.S.C. 1467a (on or after the transfer established under Section 311 of the Dodd-Frank Act)12 U.S.C. 5411)), foreign banking organization (as defined in 12 CFR 211.21(o)), state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), or Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)) that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statutes' requirements.

(c) Scope. This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after **[insert date that is 180 days after publication of the final rule in the Federal Register**]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

11. Paragraph (c) of § 237.2 is added to read as follows:

§ 237.2 Definitions.

* * * * *

(c) Covered swap entity means any state member bank (as defined in 12 CFR 208.2(g)), bank holding company (as defined in 12 U.S.C. 1842), savings and loan holding company (as defined in 12 U.S.C. 1467a (on or after the transfer established under Section 311 of the Dodd-Frank Act)12 U.S.C. 5411)), foreign banking organization (as defined in 12 CFR 211.21(o)), any state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), or Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)) that is a swap entity, or any other entity that the Board determines.

* * * * *

12. Section 237.10 is added to read as follows:

§ 237.10 Capital.

A covered swap entity shall comply with:

(a) In the case of a covered swap entity that is a state member bank (as defined in 12 CFR 208.2(g)), the capital adequacy guidelines that are applicable to the covered swap entity and have been adopted by the Board under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o);

(b) In the case of a covered swap entity that is a bank holding company (as defined in 12 U.S.C. 1842) or a savings and loan holding company (as defined in 12 U.S.C. 1467a), the capital adequacy guidelines applicable to bank holding companies under the Board's Regulation Y (12 CFR Part 225);

(c) In the case of a covered swap entity that is foreign banking organization (as defined in 12 CFR 211.21(o)) or any state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), the capital rules that are made applicable to such covered swap entity pursuant to § 225.2(r)(3) of the Board's Regulation Y (12 CFR 225.2(r)(3)); and

(d) In the case of a covered swap entity that is an Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)), the capital adequacy guidelines that are made applicable to an Edge corporation engaged in banking pursuant to § 211.12(c)(2) of the Board's Regulation K (12 CFR 211.12(c)(2)).

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Chapter III

List of Subjects
12 CFR Part 324

Banks, Reporting and recordkeeping requirements, Holding companies, Savings associations.

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Federal Deposit Insurance Corporation proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 324 to chapter III of Title 12, Code of Federal Regulations, modified as follows:

PART 324 —MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

13. The authority citation for part 324 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o-10(e), and 12 U.S.C. 1818 and 12 U.S.C. 1819(a)(Tenth).

14. Part 324 is added as set forth at the end of the Common Preamble.

15. Part 324 is amended by:
a. Removing "[Agency]" wherever it appears and adding in its place "the FDIC";
b. Removing "[The Agency]" wherever it appears and adding in its place "The FDIC"; and
c. Removing "[capital metric]" wherever it appears and adding in its place "tier 1 capital".

16. Section 324.1 is added to read as follows:

§ __.1 Authority, purpose, and scope.

(a) Authority. This part is issued by the Federal Deposit Insurance Corporation (FDIC) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)), section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)), and section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818).

(b) Purpose. Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o-8) require the FDIC to establish capital and margin requirements for any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System or FDIC-insured state-chartered savings association that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This part implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statutes and related terms, establishing capital and margin requirements, and explaining the statutes' requirements.

(c) Scope. This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after **[insert date that is 180 days after publication of the final rule in the Federal Register**]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

17. Paragraph (c) of § 324.2 is added to read as follows:

* * * * *

(c) Covered swap entity means any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System or FDIC-insured state-chartered savings association that is a swap entity, or any other entity that the FDIC determines.

* * * * *

18. Section 324.10 is added to read as follows:

§ __.10 Capital requirement.

A covered swap entity shall comply with the capital adequacy guidelines that are applicable to the covered swap entity and have been adopted by the FDIC under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o).

FARM CREDIT ADMINISTRATION
12 CFR Part 624

List of Subjects

Agriculture, Banks, Banking, Credit, Rural areas.

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Farm Credit Administration proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 624 to chapter VI of Title 12, Code of Federal Regulations, modified as follows:

PART 624 —MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

19. The authority citation for part 624 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o-10(e), and secs. 4.3, 5.9, 5.17, and 8.32 of the Farm Credit Act (12 U.S.C. 2154, 12 U.S.C. 2243, 12 U.S.C. 2252, and 12 U.S.C. 2279bb-1).

20. Part 624 is added as set forth at the end of the Common Preamble.

21. Part 624 is amended by:

a. Removing "[Agency]" wherever it appears and adding in its place "the FCA";

a. Removing "[The Agency]" wherever it appears and adding in its place "The FCA"; and

c. Removing "[capital metric]" wherever it appears and adding in its place "core surplus or core capital, as applicable".

22. Section 624.1 is added to read as follows:

§ 624.1 Authority, purpose, and scope.

(a) Authority. This part is issued by the Farm Credit Administration (FCA) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)), section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)), and sections 4.3, 5.9, 5.17, and 8.32 of the Farm Credit Act (12 U.S.C. 2154, 12 U.S.C. 2243, 12 U.S.C. 2252, and 12 U.S.C. 2279bb-1).

(b) Purpose. Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o-8) require the FCA to establish capital and margin requirements for any System institution, including the Federal Agricultural Mortgage Corporation, chartered under the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 et seq.) that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statute's requirements.

(c) Scope. This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after **[insert date that is 180 days after publication of the final rule in the Federal Register**]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

23. Paragraph (c) of § 624.2 is added to read as follows:

* * * * *

(c) Covered swap entity means any institution chartered under the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 et seq.) that is a swap entity, or any other entity that the FCA determines.

* * * * *

24. Section 624.10 is added to read as follows:

§ 624.10 Capital requirement.

A covered swap entity shall comply with:

(a) In the case of the Federal Agricultural Mortgage Corporation, the capital adequacy regulations set forth in 12 CFR Part 652; and

(b) In the case of any Farm Credit System institution other than the Federal Agricultural Mortgage Corporation, the capital regulations set forth in 12 CFR Part 615.

25. Section 624.11 is added to read as follows:

§ 624.11 Special requirements for transactions between swap entities and System institutions.

(a) Margin requirements. To the extent that a System institution, including the Federal Agricultural Mortgage Corporation, that is not a covered swap entity enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the System institution shall:

(1) Collect initial margin from the swap entity in an amount and at such times as would be in accordance with the requirements of § 624.3, provided that for purposes of this § 624.10 any reference to "initial margin model" in the definition of "initial margin collection amount" shall mean:

(i) The System institution's initial margin model, if any, or

(ii)(A) If the System institution does not have an initial margin model, an initial margin model used by a third party to calculate initial margin on behalf of the System institution in accordance with § 624.3, provided that the third party is itself independent of the swap entity that is the counterparty in the transaction at issue.

(B) The amounts of initial margin collected under this paragraph may be adjusted for minimum transfer amounts as allowed under § 624.3(c).

(2) Collect variation margin daily from the swap entity in an amount that would be in accordance with the requirements in §§ 624.4(a) and 624.4(e). The amounts of variation margin collected under this paragraph may be adjusted as allowed for minimum transfer amounts under § 624.4(c) and for qualifying master netting agreements under § 624.4(d).

(b) Documentation. To the extent that a System institution enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the System institution shall execute trading documentation with such swap entity in accordance with the requirements of § 624.5.

(c) Collateral. Any initial or variation margin that a System institution is required to collect from a swap entity under paragraph (a) of this section shall meet the eligible collateral requirements of § 624.6.

(d) Segregation. A System institution shall require that any funds or other property that it posts to a swap entity as initial or variation margin be held by a third-party custodian that is independent of the swap entity and the System institution, is located in a jurisdiction that applies the same insolvency regime to the third-party custodian as would apply to the System institution, and is subject to the rehypothecation, reinvestment, and other transfer restrictions of § 624.7

(e) Initial margin models. To the extent the initial margin collection amount that the System institution is required to collect from a swap entity under paragraph (a)(1) of this section is calculated by the System institution using an initial margin model, such model must meet all the requirements of § 624.8, provided that the appropriate prudential regulator responsible for making or rescinding any approvals to the extent required or allowed under § 624.8 shall be:

(1) In the case where the initial margin model is that of a third party that is subject to regulation by a prudential regulator, the prudential regulator having such jurisdiction; or

(2) In the case where the initial margin model is that of either the System institution or a third party that is not subject to regulation by a prudential regulator, the FCA.

FEDERAL HOUSING FINANCE AGENCY

List of Subjects
12 CFR Part 1221

Government-sponsored enterprises, Mortgages, Securities.

Authority and Issuance

For the reasons stated in the Supplementary Information, and under the authority of 7 U.S.C. 6s(e), 15 U.S.C. 78o-10(e), and 12 U.S.C. 4526, the Federal Housing Finance Agency proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 1221 of subchapter B of chapter XII of title 12 of the Code of Federal Regulations, modified as follows:

CHAPTER XII – FEDERAL HOUSING FINANCE AGENCY

SUBCHAPTER B – ENTITY REGULATIONS

PART 1221 —MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

26. The authority citation for part 1221 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o-10(e), 12 U.S.C. 4513 and 12 U.S.C. 4526(a).

27. Part 1221 is added as set forth at the end of the Common Preamble.

28. Part 1221 is amended by:

a. Removing “[Agency]” wherever it appears and adding in its place “FHFA”;
b. Removing “[The Agency]” wherever it appears and adding in its place “FHFA”; and
c. Removing “[capital metric]” wherever it appears and adding in its place “total capital”.

29. Section 1221.1 is added to read as follows:

§ 1221.1 Authority, purpose, and scope.

(a) Authority. This part is issued by the Federal Housing Finance Authority (FHFA) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)), section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)), 12 U.S.C. 4513 and 12 U.S.C. 4526(a).

(b) Purpose. Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o-8) require FHFA to establish capital and margin requirements for any regulated entity that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statute's requirements.

(c) Scope. This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after **[insert date that is 180 days after publication of the final rule in the Federal Register**]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than is required under this part.

30. Section 1221.2 is amended as follows:

a. Add paragraph (c);

b. Redesignate paragraphs (z), (aa) and (bb) as paragraphs (bb), (cc), and (dd), respectively;

c. Redesignate paragraphs (u) through (y) as (v) through (z); and

d. Add new paragraphs (u) and (aa).

§ 1221.2 Definitions.

* * * * *

(c) Covered swap entity means any regulated entity that is a swap entity, or any other entity that FHFA determines.

* * * * *

(u) Regulated entity means any regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)).

* * * * *

(aa) Total capital means:

(1) In the case of any Federal Home Loan Bank, "total capital" as such term is defined in 12 CFR 1229.1; and

(2) In the case of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or any of their respective affiliates, "total capital" as such term is defined in 12 CFR 1750.11.

* * * * *

31. Section 1221.10 is added to read as follows:

§ 1221.10 Capital .

A covered swap entity shall comply with the risk-based capital level or such other amount applicable to the covered swap entity as required by the Director of FHFA pursuant to 12 U.S.C. 4611.

32. Section 1221.11 is added to read as follows:

<u>§ 1221.11 Special Requirements for Transactions Between Swap Entities and Regulated Entities.</u>

(a) <u>Margin Requirements</u>. To the extent that a regulated entity that is not a covered swap entity enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the regulated entity shall:

(1) Collect initial margin from the swap entity in an amount and at such times as would be in accordance with the requirements of § 1221.3, provided that for purposes of this section any reference to "initial margin model" in the definition of "initial margin collection amount" shall mean:

(i) The regulated entity's initial margin model, if any, or

(ii)(A) If the regulated entity does not have an initial margin model, an initial margin model used by a third party to calculate initial margin on behalf of the regulated entity in accordance with § 1121.3, provided that the third party is itself independent of the swap entity that is the counterparty in the transaction at issue.

(B) The amounts of initial margin collected under this paragraph may be adjusted for minimum transfer amounts as allowed under § 1221.3(c).

(2) Collect variation margin daily from the swap entity in an amount that would be in accordance with the requirements in § 1221.4(a) and § 1221.4(e). The amounts of variation margin collected under this paragraph may be adjusted as allowed for minimum transfer amounts under § 1221.4(c) and for qualifying master netting agreements under § 1221.4(d).

(b) <u>Documentation</u>. To the extent that a regulated entity enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the regulated entity shall execute trading documentation with such swap entity in accordance with the requirements of § 1221.5.

(c) <u>Collateral</u>. Any initial or variation margin that a regulated entity is required to collect from a swap entity under paragraph (a) of this section shall meet the eligible collateral requirements of § 1221.6.

(d) <u>Segregation</u>. A regulated entity shall require that any funds or other property that it posts to a swap entity as initial or variation margin be held by a third-party custodian that is independent of the swap entity and the regulated entity, is located in a jurisdiction that applies the same insolvency regime to the third-party custodian as would apply to the regulated entity, and is subject to the rehypothecation, reinvestment, and other transfer restrictions of § 1221.7.

(e) <u>Initial margin models</u>. To the extent the initial margin collection amount that the regulated entity is required to collect from a swap entity under paragraph (a)(1) of this section is calculated by the regulated entity using an initial margin model, such model must meet all the requirements of § 1221.8, provided that the appropriate prudential regulator responsible for making or rescinding any approvals or taking other action to the extent required or allowed under § 1221.8 shall be:

(1) In the case where the initial margin model is that of a third party that is subject to regulation by a prudential regulator, the prudential regulator having such jurisdiction; or

(2) In the case where the initial margin model is that of either the regulated entity or a third party that is not subject to regulation by a prudential regulator, FHFA.

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES"]

Dated: April 11, 2011

John Walsh,
Acting Comptroller of the Currency.

BILLING CODE 4810-33-P

[THIS SIGNATURE PAGE RELATES TO THE JOINT NOTICE OF PROPOSED RULE ENTITLED "MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES"]

By order of the Board of Governors of the Federal Reserve System, April 12, 2011.

Jennifer J. Johnson,
Secretary of the Board.
BILLING CODE 6210-01-P

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES"]

Dated at Washington, D.C., this 12th of April 2011.
By order of the Board of Directors.
Federal Deposit Insurance Corporation.

Robert E. Feldman,
Executive Secretary

Billing Code: 6714–01–P

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES"]

Dated: April 11, 2011

Dale L. Aultman
Secretary,
Farm Credit Administration Board

Billing Code: 6705-01P

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES"]

Dated: April 11, 2011

Edward J. DeMarco,
Acting Director, Federal Housing Finance Agency.

Billing Code: 8070-01P

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[2] See 7 U.S.C. 1a(47); 15 U.S.C. 78c(a)(68). Swaps and security-based swaps are sometimes referred to herein collectively as "derivatives."

[3] See 7 U.S.C. 6s; 15 U.S.C. 78o-8. Section 731 of the Dodd-Frank Act requires swap dealers and major swap participants to register with the Commodity Futures Trading Commission (the "CFTC"), which is vested with primary responsibility for the oversight of the swaps market under title 7 of the Dodd Frank Act. Section 764 of the Dodd-Frank Act requires security-based swap dealers and major security-based swap participants to register with the Securities and Exchange Commission (the "SEC"), which is vested with primary responsibility for the oversight of the security-based swaps market under title 7 of the Dodd-Frank Act. Section 713(d)(1) of the Dodd-Frank Act requires the CFTC and SEC to issue joint rules further defining the terms swap dealer, major swap participant, security-based swap dealer, and major security-based swap participant. The CFTC and SEC issued a joint notice of proposed rulemaking with respect to these definitions in December, 2010. See 75 FR 80,174 (Dec. 21, 2010) (proposed rule).

[4] Section 1a(39) of the Commodities Exchange Act defines the term "prudential regulator" for purposes of the capital and margin requirements applicable to swap dealers, major swap participants, security-based swap dealers and major security-based swap participants. The Board is the prudential regulator for any swap entity that is (i) a State-chartered bank that is a member of the Federal Reserve System, (ii) a State-chartered branch or agency of a foreign bank, (iii) a foreign bank which does not operate an insured branch, (iv) an organization operating under section 25A of the Federal Reserve Act (an Edge corporation) or having an agreement with the Board under section 25 of the Federal Reserve Act (an Agreement corporation), and (v) a bank holding company, a foreign bank that is treated as a bank holding company under section 8(a) of the International Banking Act of 1978, or a savings and loan holding company (on or after the transfer date established under section 311 of the Dodd-Frank Act), or a subsidiary of such a company or foreign bank (other than a subsidiary for which the OCC or FDIC is the prudential regulator or that is required to be registered with the CFTC or SEC as a swap dealer or major swap participant or a security-based swap dealer or major security-based swap participant, respectively). The OCC is the prudential regulator for any swap entity that is a national bank, a federally chartered branch or agency of a foreign bank, or a Federal savings association. The FDIC is the prudential regulator for any swap entity that is (i) a State-chartered bank that is not a member of the Federal Reserve System or (ii) a State savings association. The FCA is the prudential regulator for any swap entity that is an institution chartered under the Farm Credit Act of 1971, as amended. FHFA is the prudential regulator for any swap entity that is a "regulated entity" under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (i.e., the Federal National Mortgage Association and its affiliates, the Federal Home Loan Mortgage Corporation and its affiliates, and the Federal Home Loan Banks). See 7 U.S.C. 1a(39).

[5] See 7 U.S.C. 6s(e)(2)(A); 15 U.S.C. 78o-8(e)(2)(A). Section 6(s)(e)(1)(A) directs registered swap dealers and major swap participants for which there is a prudential regulator to comply with margin and capital rules issued by the prudential regulators, while section 6(s)(e)(1)(B) directs registered swap dealers and major swap participants for which there is not a prudential regulator to comply with margin and capital rules issued by the CFTC and SEC. Section 78o-8(e)(1) generally parallels section 6s(e)(1), except that section 78o-8(e)(1)(A) refers to registered security-based swap dealers and major security-based swap participants for which "there is not a prudential regulator." The Agencies construe the "not" in section 78o-8(e)(1)(A) to have been included by mistake, in conflict with section 78o-8(e)(2)(A), and of no substantive meaning. Otherwise, registered security-based swap dealers and major security-based swap participants for which there is not a prudential regulator could be subject to multiple capital and margin rules, and institutions regulated by the prudential

regulators and registered as security-based swap dealers and major security-based swap participants might not be subject to any capital and margin requirements under section 78o-8(e).

[6] See 7 U.S.C. 6s(e)(2)(B); 15 U.S.C. 78o-8(e)(2)(B).

[7] See 7 U.S.C.§ 6s(e)(2)(A); 6s(e)(3)(D); 15 U.S.C.§ 78o-8(e)(2)(A), 78o-8(e)(3)(D). Staff of the Agencies have consulted with staff of the CFTC and SEC in developing the proposed rule.

[8] See 7 U.S.C. 6s(e)(3)(A); 15 U.S.C. 78o-8(e)(3)(A).

[9] See 7 U.S.C. 6s(e)(3)(A); 15 U.S.C. 78o-8(e)(3)(A). In addition, Section 1201 of Housing and Economic Recovery Act of 2008 (Pub. L. 110-289, 122 Stat. 2654) requires the Director of FHFA, when promulgating regulations relating to the Federal Home Loan Banks, to consider the following differences between the Federal Home Loan Banks and the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac): cooperative ownership structure; mission of providing liquidity to members; affordable housing and community development mission; capital structure; and joint and several liability. See section 1201 Pub. L. 110-289, 122 Stat. 2782-83 (amending 12 U.S.C. 4513). The Director of FHFA also may consider any other differences that are deemed appropriate. For purposes of this proposed rule, FHFA considered the differences as they relate to the above factors. FHFA requests comments from the public about whether differences related to these factors should result in any revisions to the proposal.

[10] See 7 U.S.C. 6s(e)(2)(C); 15 U.S.C. 78o-8(e)(2)(C). In addition, the margin requirements imposed by the Agencies must permit the use of noncash collateral, as the Agencies determine to be consistent with (i) preserving the financial integrity of the markets trading swaps and security-based swaps and (ii) preserving the stability of the U.S. financial system. See 7 U.S.C. 6s(e)(3)(C); 15 U.S.C. 78o-8(e)(3)(C).

[11] See Dodd Frank Act §§ 754, 774.

[12] See 7 U.S.C. 2(h); 15 U.S.C. 78c-3. Certain types of counterparties (e.g., counterparties that are not financial entities and are using swaps or security-based swaps to hedge or mitigate commercial risks) are exempt from this mandatory clearing requirement and may elect not to clear a swap or security-based swap that would otherwise be subject to the clearing requirement.

[13] G-20 Leaders, June 2010 Toronto Summit Declaration, ¶ 25. The dealer community has also recognized the importance of clearing–beginning in 2009, in an effort led by the Federal Reserve Bank of New York, the dealer community agreed to increase central clearing for certain credit derivatives and interest rate derivatives. See Press Release, Federal Reserve Bank of New York, New York Fed Welcomes Further Industry Commitments on Over-the-Counter Derivatives press release (June 2, 2009), available at www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html.

[14] CCPs interpose themselves between counterparties to a derivative transaction, becoming the buyer to the seller and the seller to the buyer and, in the process, taking on the credit risk that each party poses to the other. For example, when a derivatives contract between two parties that are members of a CCP is executed and submitted for clearing, it is typically replaced by two new contracts—separate contracts between the CCP and each of the two original counterparties. At that point, the original counterparties are no longer counterparties to each other; instead, each faces the CCP as its counterparty, and the CCP assumes the counterparty credit risk of each of the original counterparties.

[15] See proposed rule §§ __.2(b), (g), (h), (i), (n), (r) and (y) for the various constituent definitions that identify these four types of swap counterparties.

[16] Section __.11 of the proposed rule adopted by FHFA and FCA (but not the other Agencies) requires that their regulated entities collect initial and variation margin from swap entities, as described in section III.K of this notice.

[17] See proposed rule, Appendix A.

[18] See proposed rule §§ __.2(l), __.3(a), __.8.

[19] See proposed rule §§ __.2(m), __.3(a)(2).

[20] See proposed rule §§ __.2(z), __.4(a).

[21] See proposed rule §§ __.2(bb), __.4(a)(2).

[22] See proposed rule § __.4(b).

[23] See proposed rule § __.6.

[24] See proposed rule § __.7. The Agencies note that sections 724 and 763 of Dodd-Frank Act require a swap entity to offer its swap and security-based swap counterparties the option of requiring segregation of initial margin they post to the swap entity.

[25] 7 U.S.C. 6s(e)(2); 15 U.S.C. 78o-8(e)(2).

[26] See 54 FR 4186 (January 27, 1989). The general banking risk-based capital rules are codified at 12 CFR part 3, Appendix A (OCC); 12 CFR parts 208 and 225, Appendix A (Board); and 12 CFR part 325, Appendix A (FDIC).

[27] The Basel Committee on Banking Supervision (BCBS) developed the first international banking capital framework in 1988, entitled International Convergence of Capital Measurement and Capital Standards.

[28] 61 FR 47358 (September 6, 1996). The banking agencies' market risk capital rules are at 12 CFR part 3, Appendix B (OCC); 12 CFR part 208, Appendix E and 12 CFR part 225, Appendix E (Board); and 12 CFR part 325, Appendix C (FDIC). The rules apply to banks and bank holding companies with trading activity (on a worldwide consolidated basis) that equals 10 percent or more of the institution's total assets, or $1 billion or more.

[29] See BCBS, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (2006). The banking agencies implemented the advanced approaches of the Basel II Accord in 2007. See 72 FR 69288 (December 7, 2010). The advanced approaches rules are codified at 12 CFR part 3, Appendix C (OCC); 12 CFR part 208, Appendix F and 12 CFR part 225, Appendix G (Board); and 12 CFR part 325, Appendix D (FDIC).

[30] See 53 FR 40.033 (Oct. 13, 1988); 70 FR 35.336 (June 17, 2005); 12 CFR Part 615 subpart H.

[31] See 66 FR 19,048 (April 12, 2001); 71 FR 77,247 (Dec. 26, 2006); 12 CFR Part 652.

[32] See BCBS, Basel III: A Global Regulatory Framework For More Resilient Banks and Banking Systems (2010), available at www.bis.org/publ.bcbs189.htm.

[33] For the duration of the conservatorships of Fannie Mae and Freddie Mac (together, the Enterprises), FHFA has directed that their existing regulatory capital requirements would not be binding. However, FHFA continues to closely monitor the Enterprises' activities. Such monitoring, coupled with the unique financial support available to the Enterprises from the United States Treasury and the likelihood that FHFA will promulgate new risk-based capital rules in due course to apply to the Enterprises (or their successors) once the conservatorships have ended, lead to FHFA's preliminary view that the reference to existing capital rules is sufficient to address the risks discussed in the text above as to the Enterprises.

[34] See proposed rule § __.8(b). The covered swap entity would not be permitted to selectively incorporate only certain pre-effective-date derivatives.

[35] Although the term "commercial end user" is not defined in the Dodd-Frank Act, it is generally understood to mean a company that is eligible for the exception to the mandatory clearing requirement for swaps and security-based swaps under section 2(h)(7) of the Commodity Exchange Act and section 3C(g) of the Securities Exchange Act, respectively. This exception is generally available to a person that (i) is not a financial entity, (ii) is using the swap to hedge or mitigate commercial risk, and (iii) has notified the CFTC or SEC how it generally meets its financial obligations with respect to non-cleared swaps or security-based swaps, respectively. See 7 U.S.C. 2(h)(7) and 15 U.S.C. 78c-3(g).

[36] See, e.g., 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement of Sen. Lincoln).

[37] In the case of a nonfinancial end user with a strong credit profile, under current market practices a derivatives dealer would not require margin—in essence, it would extend unsecured credit to the end user with respect to the underlying exposure. For counterparties with a weak credit profile, a derivatives dealer would likely make a different credit decision and require the counterparty to post margin.

[38] See proposed rule § __.2(y).

[39] This is consistent with the Dodd Frank Act's requirement that the Agencies set margin and capital requirements appropriate for the risk to the financial system associated with non-cleared swaps held as a swap dealer or major swap participant. 7 U.S.C. 6(e)(3)(A); 15 U.S.C. 78o-8(e)(3)(A).

[40] Although the proposed rule does not define a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company of 1956 (12 U.S.C. 1843(k)), the Agencies note that the Board has recently issued a proposed rule for comment defining a similar term for purposes of Title I of the Dodd-Frank Act. See 76 FR 7,731 (Feb. 11, 2011) (proposed rule). The Agencies request comment on whether they should apply the same methodology as is adopted for purposes of Title I of the Dodd-Frank Act for purposes of this clause of the proposed rule's definition of a financial end user, or whether an alternative methodology is appropriate.

[41] See proposed rule § __.2(h). This definition of "financial end user" is based upon, and substantially similar to, the definition of a "financial entity" that is ineligible to use the end user exemption from the mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act. See 7 U.S.C. 2(h)(7); 15 U.S.C. 78c-3(g).

[42] See proposed rule § __.2(h)(6).

[43] See proposed rule § __.2(n).

[44] See 75 FR 80,174 (Dec. 10, 2010).

[45] See 7 U.S.C. 1a(33)(A)(i)(I); 15 U.S.C. 78c(a)(67)(a)(ii)(I).

[46] See 7 U.S.C. 1a(33)(A)(iii)(I); 15 U.S.C. 78c(a)(67)(a)(ii)(III)(aa).

[47] Separately, in the case of institutions regulated by FHFA and FCA, the effect of § __.11 of the proposed rule, when combined with the margin requirements contained in other parts of the proposed rule, would also be to effectively require both parties to a non-cleared swap or non-cleared security-based swap between a swap entity and an institution regulated by FHFA or FCA to both collect and post initial margin.

[48] See proposed rule §§ __.2(k)(1), __.3(a). Although the Agencies intend to specify a particular percentage in the final rule, the proposed rule provides a potential range of percentages for comment.

[49] See proposed rule §§ __.2(k)(2), __.3(a).

[50] See proposed rule §§ __.2(m), __.3(a). A covered swap entity that has established an initial margin threshold amount for a counterparty need only collect initial margin if the required amount exceeds the initial margin threshold amount, and in such cases is only required to collect the excess amount.

[51] See proposed rule § __.2(m)(1).

[52] See proposed rule § __.2(m).

[53] Although the Agencies intend to specify particular amounts in the final rule, the proposed rule provides a potential range of numbers for comment. Since tier 1 capital is not a concept that is applicable to covered swap entities for which FHFA or the FCA is the prudential regulator, the thresholds as applied to such entities instead reference (i) in the case of covered swap entities for which FHFA is the prudential regulator, the term "total capital," as separately defined within the proposed regulatory text of FHFA's proposed rule, and (ii) in the case of covered swap entities for which the FCA is the prudential regulator, the term "applicable core surplus or core capital (or successor high quality capital requirement)," as separately defined within the proposed regulatory text

of the FCA's proposed rule.

[54] The Agencies also note that the categories of counterparties for which the proposed rule permits a covered swap entity to establish an initial margin threshold amount are roughly aligned with the Dodd-Frank Act exemption of non-financial end users from the Dodd-Frank Act mandatory clearing requirement. See 7 U.S.C. 2(h)(7); 15 U.S.C. 78c-3(g).

[55] See proposed rule § __.3(c). The minimum transfer amount only affects the timing of margin collection; it does not change the amount of margin that must be collected once the $100,000 threshold is crossed. For example, if the initial margin requirement were to increase from $50,000 to $110,000, the covered swap entity would be required to collect the entire $110,000 (subject to application of any applicable initial margin threshold amount).

[56] As described in section III.K of this notice, FHFA's and the FCA's proposed rules contain an additional provision that will have a different effect with respect to entities regulated by FHFA and the FCA.

[57] See proposed rule § __.4(a).

[58] The proposed rule defines this required amount as the "variation margin amount." See proposed rule § __.2(bb). In the case of swap or security-based swap that is out-of-the-money or in-the-money to a covered swap entity at the time it enters into the transaction, that amount is also included within the definition of variation margin amount and subject to the variation margin requirements.

[59] See proposed rule §§ __.2(bb), __.4(a).

[60] See proposed rule § __.4(d).

[61] See proposed rule § __.2(t). The proposed rule's definition of qualifying master netting agreement generally mirrors the definition given to that term in the Federal banking agencies' risk-based capital rules applicable to derivatives positions held by insured depository institutions and bank holding companies. See, e.g., 12 CFR 225, App. G.I.2.

[62] See proposed rule § __.4(e). The Agencies note that there is no similar reference to appropriate efforts in the proposed rule initial margin requirements; since initial margin is collected at the time a swap or security-based swap is entered into, a covered swap entity can and must collect any required initial margin as prerequisite to executing the transaction

[63] See proposed rule § __.5.

[64] See id.

[65] See proposed rule § _6(a). An obligation will be considered to be fully guaranteed as to principal and interest by the United States if the guarantee commits the full faith and credit of the United States for the repayment of principal and interest on the obligation. "Insured obligations" of Farm Credit System banks are consolidated and System-wide obligations issued by Farm Credit System banks. These obligations are insured by the Farm Credit System Insurance Corporation out of funds in the Farm Credit Insurance Fund. Should the Farm Credit Insurance Fund ever be exhausted, Farm Credit System banks are jointly and severally liable for payment on insured obligations.

[66] See proposed rule § _6(b). With respect to these haircuts, although the Agencies intend to specify particular haircut amounts in the final rule, the proposed rule provides a potential range of haircuts for comment.

[67] See proposed rule § _6(d).

[68] See proposed rule § _6(c).

[69] See proposed rule § _7(a).

[70] See proposed rule §§ _7(b), (c).

[71] See proposed rule § _7(d).

[72] The proposed rule does not apply the segregation requirement to variation margin because

variation margin is generally used to offset the current exposure arising from actual changes in the market value of the derivative position, rather than to secure potential exposure arising from future changes in the market value of the derivative position. Under section __.11 of FHFA's and the FCA's proposed rules, entities regulated by FHFA and the FCA that are end users would have to require that any initial margin and variation margin they post to swap entities be segregated.

[73] For example, if dealer A and dealer B entered into a swap with each other under which each was required to collect $100 from the other in initial margin without segregation, each would collect $100 in initial margin from the other and no net initial margin would be exchanged. In the case of a bankruptcy of dealer B, dealer A would be permitted to set off the $100 loss that may be incurred in replacing the swap against the $100 in initial margin it "collected" from dealer B, but then would face the potential loss of the $100 in initial margin it provided to dealer B, for which it would only have a claim in bankruptcy. If instead the initial margin for such a swap had been segregated, dealer A would be permitted to set off the $100 loss that may incurred in replacing the swap against the $100 in initial margin that dealer B pledged to dealer A at a third-party custodian, and dealer A could also recover the $100 in initial margin that it pledged to dealer B at a third-party custodian, with the result that dealer A would incur no loss upon dealer B's bankruptcy.

[74] Although the agreements between the counterparties might not allow for requests for segregation after a swap transaction has been confirmed, as a practical matter counterparties might refuse to enter into any additional transactions with a financially-stressed swaps entity absent an accommodation to segregate some amount of initial margin for the existing portfolio of swaps between the two parties.

[75] This conservative approach also incorporates the practices associated with model validation, independent review and other qualitative requirements associated with the use of internal models for regulatory capital purposes.

[76] See proposed rule § __.8(d)(1).

[77] See proposed rule § __.8(b).

[78] Id.

[79] See proposed rule § __.8(d)(11).

[80] See proposed rule § __.8(d)(14).

[81] Section 2(i) of the Commodity Exchange Act, as amended by section 722 of the Dodd-Frank Act, provides that the provisions of the Commodity Exchange Act relating to swaps "shall not apply to activities outside of the United States unless those activities … have a direct and significant connection with activities in, or effect on, commerce of the United States."

[82] See proposed rule § __.9(a).

[83] See proposed rule § __.9(b).

[84] Under the proposed rule, swap and security-based swaps with U.S. counterparties are subject to the proposed rule's margin requirements regardless of whether the covered swap entity is U.S. or foreign.

[85] See proposed rule § __.9(c).

[86] See proposed rule § __.10.

[87] For example, under the banking agencies' capital adequacy standards for banks and bank holding companies based on the first Basel Accord, interest-rate, exchange-rate, commodity, and equity-linked derivative contracts that are not traded on an exchange are subject to a capital charge based on type of contract, remaining maturity, and the risk category of the counterparty to the contract. See 12 CFR part 3, Appendix A § 3(b)(7) (OCC); 12 CFR parts 208 and 225, Appendix A § III.E (Board); 12 CFR part 325, Appendix A § II.E (FDIC). As another example, under the bank agencies' advanced risk-based capital adequacy standards based on the advanced approaches of the Basel II Accord ("advanced approaches"), banks and bank holding companies that use the advanced approaches determine capital requirements for over-the-counter derivatives based on a formula that

takes into account collateral in mitigating counterparty credit risk. See 12 CFR part 3, Appendix C, part IV (OCC); 12 CFR part 208, Appendix F, part IV and 12 CFR part 225, Appendix G, part IV (Board); and 12 CFR part 325, Appendix D, part IV (FDIC). The FCA's capital requirements for FCS institutions other than Farmer Mac expressly address derivatives transactions. See 12 CFR 615.5201 and 615.5212. The FCA's capital requirements for Farmer Mac indirectly address derivatives transactions in the operational risk component of the statutorily mandated risk-based capital stress test model. See 12 CFR Part 652 Subpart B Appendix A. The FCA, through the Office of Secondary Market Oversight, closely monitors and supervises all aspects of Farmer Mac's derivatives activities, and the FCA believes existing requirements and supervision are sufficient to ensure safe and sound operations in this area. However, the FCA is considering enhancements to the model and in the future may revise the model to more specifically address derivatives transactions.

[88] See footnote 33, supra, for a discussion of the basis for FHFA's preliminary view that the reference to existing statutory authority is sufficient to address the risks discussed in the text above as to the Enterprises notwithstanding their current conservatorship status.

[89] See FCA and FHFA proposed rule § __.11. FCA and FHFA note that in sections III.C and III.D of this notice of proposed rulemaking, the Agencies have requested comment on alternative approaches to margin requirements, including whether covered swap entities should be required to post margin to end users. In the event such an alternative approach is adopted as part of a final rule, as to both initial and variation margin requirements, FCA and FHFA note that this proposed § __.11 may not need to be adopted as part of that final rule.

[90] See 12 U.S.C.§ 2154, 2248, 2252, 4513, 4526.

[91] U.S. Small Business Administration, Table of Small Business Size Standards Matched to North American Industry Classification System Codes, available at www.sba.gov/sites/default/files/Size_Standards_Table.pdf.

76 FR 37029, 06/24/2011

Handbook Mailing HM-11-8

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 45
Docket No. OCC-2011-0008
RIN: 1557-AD43

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
12 CFR Part 237
Docket No. R-1415
RIN: 7100 AD74

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 324
RIN: 3064-AD79

FARM CREDIT ADMINISTRATION
12 CFR Part 624
RIN: 3052-AC69

FEDERAL HOUSING FINANCE AGENCY
12 CFR Part 1221
RIN: 2590-AA45

MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Farm Credit Administration (FCA); and the Federal Housing Finance Agency (FHFA).

ACTION: Proposed rule; extension of comment period.

SUMMARY: On May 11, 2011, the OCC, Board, FDIC, FCA, and FHFA (collectively, the Agencies) published in the Federal Register a joint notice of proposed rulemaking for public comment to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the Agencies is the prudential regulator (the proposed rule).

Due to the complexity of the rulemaking, to allow parties more time to consider the impact of the proposed rule, and so that the comment period on the proposed rule will run concurrently with the comment period for similar margin and capital requirements proposed by the Commodity Futures Trading Commission, the Agencies have determined that an extension of the comment period until July 11, 2011 is appropriate. This action will allow interested persons additional time to analyze the proposed rules and prepare their comments.

DATES: Comments on the proposed rule must be received on or before July 11, 2011.

ADDRESSES: You may submit comments by any of the methods identified in the proposed rule. Please submit your comments using only one method.

FOR FURTHER INFORMATION CONTACT:

OCC: Michael Sullivan, Director, Market RAD (202) 874-3978, Kurt Wilhelm, Director, Financial Markets Group (202) 874-4479, Jamey Basham, Assistant Director, Legislative and Regulatory Activities Division (202) 874-5090, or Ron Shimabukuro, Senior Counsel, Legislative and Regulatory Activities Division (202) 874-5090, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

Board: Sean D. Campbell, Deputy Associate Director, Division of Research and Statistics, (202) 452-3761, Michael Gibson, Senior Associate Director, Division of Research and Statistics, (202) 452-2495, or Jeremy R. Newell, Senior Attorney, Legal Division, (202) 452-3239, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington , D.C. 20551.

FDIC: Bobby R. Bean, Chief, Policy Section, (202) 898-6705, John Feid, Senior Capital Markets Specialist, (202) 898-8649, Division of Risk Management Supervision, Thomas F. Hearn, Counsel, (202) 898-6967, or Ryan K. Clougherty, Senior Attorney, (202) 898-3843, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

FHFA: Robert Collender, Principal Policy Analyst, Office of Policy Analysis and Research, 202-343-1510, Robert.Collender@fhfa.gov, Peggy Balsawer, Assistant General Counsel, Office of General Counsel, 202-343-1529, Peggy.Balsawer@fhfa.gov, or James Carley, Senior Associate Director, Division of FHLBank Regulation, 202-408-2507, James.Carley@fhfa.gov, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877-8339.

FCA: William G. Dunn, Acting Associate Director, Finance and Capital Markets Team, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434, Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4434, or Rebecca S. Orlich, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

On May 11, 2011, the proposed rule was published in the Federal Register.[1] The proposed rule would establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the Agencies is the prudential regulator, as required under sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).[2] Sections 731 and 764 of the Dodd-Frank Act add a new section 4s to the Commodity Exchange Act and a new section 15F to the Securities Exchange Act of 1934, respectively, which require the registration and regulation of swap dealers and major swap participants and security-based swap dealers and major security-based swap participants (collectively, swap entities). For certain types of swap entities that are prudentially regulated by one of the Agencies, sections 731 and 764 of the Dodd-Frank Act require the Agencies to adopt rules jointly for swap entities under their respective jurisdictions imposing (i) capital requirements and (ii) initial and variation margin requirements on all non-cleared swaps and non-cleared security-based swaps. In recognition of the complexities of the rulemaking and the variety of considerations involved in its impact and implementation, the Agencies requested that commenters respond to numerous questions. The proposed rule stated that the public comment period would close on June 24, 2011.[3]

The Agencies have received requests from the public for an extension of the comment period.[4] The Agencies believe that it is important to allow parties more time to consider the impact of the proposed rule, and to extend the comment period on the proposed rule so that it will run concurrently with the comment period for similar margin and capital requirements proposed by the Commodity Futures Trading Commission.[5] Therefore, the Agencies are extending the deadline for submitting comments on the proposed rule from June 24, 2011 to July 11, 2011.

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[1] See 76 FR 27564.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law 111-203, 124 Stat. 1376 (2010).

[3] See id.

[4] See comment letter to the OCC, Board, and FDIC from American Bankers Association et al. (June 17, 2011).

[5] See 76 FR 23732; 76 FR 27621.

Dated: June 21, 2011

Julie L. Williams,
First Senior Deputy Comptroller and Chief Counsel

By order of the Board of Governors of the Federal Reserve System, acting through the Secretary under delegated authority, June 22, 2011.

Jennifer J. Johnson,
Secretary of the Board.

Dated at Washington, D.C., this 21 of June 2011.
Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary

Date: June 21, 2011

Dale L. Aultman
Secretary,
Farm Credit Administration Board.

June 21, 2011

Stephen M. Cross,
Deputy Director of the Division of Bank Regulation
By delegation
Federal Housing Finance Agency.

77 FR 8179, 02/14/2012

Handbook Mailing HM-12-2

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 630

RIN 3052-AC77

Disclosure to Investors in System-wide and Consolidated Bank Debt Obligations of the Farm Credit System

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, us, we, or our) proposes to amend our regulations related to the Federal Farm Credit Banks Funding Corporation (Funding Corporation) System Audit Committee (SAC) and the Farm Credit System (System) annual report to investors. The proposed rule would remove the provision that a two-thirds majority vote of the Funding Corporation board of directors be required to deny a request for resources by the SAC to engage independent legal counsel, outside advisors or consultants. The proposed rule would instead require appropriate funding to the SAC to perform these duties, quarterly reporting by the SAC to the Funding Corporation board on resources used, and annual reporting to investors.

DATES: Submit comments on or before April 16, 2012.

ADDRESSES: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we no longer accept comments submitted by fax. Regardless of the method you use, please do not submit your comments multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send an e-mail to reg-comm@fca.gov.

- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."

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

- Mail: Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Deborah Wilson, Senior Accountant, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434,

or

Laura McFarland, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of this proposed rule are to:

- Allow the SAC unrestricted access to resources to engage legal counsel, consultants and outside advisors,

- Ensure that investors are provided transparent and complete disclosure on the safe and sound use of resources by the SAC, and

- Clarify that the appointment, compensation, and retention of the external auditor for the System-wide reports cannot be changed without the agreement of both the SAC and the Funding Corporation board.

II. Background

The Farm Credit Act of 1971, as amended (Act),[1] authorizes the FCA to issue regulations implementing the Act's provisions.[2] Our regulations are intended to ensure the safe and sound operations of System institutions and to govern the disclosure of financial information to shareholders of, and investors in, the System. In 2006, we issued a final rulemaking on the governance of System institutions.[3] Those regulations changed the structure, responsibilities, and authority of existing audit committees at the banks and the SAC, and it required audit committees at System associations.

We explained in our 2006 rulemaking that an audit committee is the guardian of an institution's financial integrity, and its independence is essential to investor confidence in the transparency of audited financial statements. The 2006 rulemaking required that audit committees at banks and associations be comprised solely of well-qualified board members,[4] but made an exception to the composition of the SAC. Section 630.6(a) requires that only one-third of the SAC membership be composed of directors from the Funding Corporation board. This exception was in response to comments received on the 2006 rulemaking that audit committee composition derived solely from the board of directors may be appropriate for individual System institutions, but not for the SAC. Commenters believed that the duties of the SAC require broader representation and greater financial experience of its members due to its oversight for the preparation of System combined financial statements.

The 2006 rulemaking required that the SAC be permitted to contract for independent legal counsel and expert advisers and that the Funding Corporation provide monetary and nonmonetary resources for these activities. Also, the rulemaking required a two-thirds super majority vote, in lieu of a simple majority vote, of the full Funding Corporation board to deny an SAC request for resources. In a petition dated May 2010, the SAC requested that we amend § 630.6 to allow it unfettered ability to engage outside advisors, consultants and legal counsel in the performance of its duties. On November 18, 2010, we issued an advance notice of proposed rulemaking (ANPRM) on senior officer compensation disclosures and related topics in order to gather information for the development of a proposed rulemaking.[5] Part of the ANPRM discussed the authority of the SAC to obtain resources. Among the comment letters received in response to the ANPRM, several responders, including the Farm Credit Council (Council) acting for its membership, and the Funding Corporation, addressed the ability of the SAC to have unfettered ability to access resources. The Council expressed the view of its membership that existing FCA regulations appropriately balance audit committee need with the board's ultimate responsibility to the customer-shareholder for the safety and financial stability of the institution. However, the Council also noted that its membership supported the SAC's request.

This proposed rule would expand the authority of the SAC related to its use of Funding Corporation resources for consultants, legal counsel and outside advisors. In its petition, the SAC asserted that expanding its authority on the use of resources would:

- Avoid any future potential conflict that could arise between it and the Funding Corporation board on SAC requests for resources,

- Enhance its independence, and

- Promote the integrity of the System both in fact and perception to investors in System-wide debt securities.

We considered these views in proposing this rule. The rule proposes that the SAC report to the board at least quarterly on its use of resources, and the Funding Corporation disclose the uses and their benefits in the System annual report to investors. Further, we propose to clarify that the SAC appoint, compensate, retain and oversee the System's independent accountants with the agreement of the Funding Corporation board.

III. <u>Section-by-Section Analysis</u>

We request and encourage any interested person to submit comments on this proposed rule and ask that you support your comments with relevant data or examples. We are especially interested in receiving comments related to the proposed clarification that the SAC appoint, compensate, and retain external auditors with the agreement of the Funding Corporation board of directors.

A. <u>System Audit Committee Authority</u> [§ 630.6(a)]

FCA regulations authorize the Funding Corporation board of directors to deny an SAC request for resources by a two-thirds majority vote of the full board. The proposed rule would provide the SAC with the unlimited ability to engage outside advisors, consultants and legal counsel in the performance of its duties. This proposed rule would require that the SAC use Funding Corporation resources in a manner that would not adversely affect the safety and soundness of the System and that the use of resources complies with law and regulation. Also, it would require that the SAC report to the Funding Corporation board at least quarterly on resources used pursuant to this proposed rule.

This provision would not prevent the Funding Corporation from developing its own procedures to address the use of resources by the SAC. To facilitate an open and balanced discussion on the appropriate use of resources, we would expect the SAC to confer with the Funding Corporation board on its intent to use resources. We would also expect that in performing its fiduciary responsibilities, the full board would review the use of resources for any safety or soundness issues.

B. External Auditors [§ 630.6(a)(4)(ii)(A)]

The proposed rule would revise our regulation relating to the appointment, compensation and retention of the external auditor. The revision would clarify that the SAC perform this duty with the agreement of the Funding Corporation board. We believe this clarification will ensure that the SAC's appointment, compensation and retention of the external auditor for the System-wide report are executed with the agreement of the full board of the Funding Corporation. Since the SAC is a subset of the full board, we believe the SAC duties related to the external auditors are of such significance that they must remain under the direct oversight of the full board.

C. Disclosure of System Audit Committee Expenditures [§ 630.20(n)]

To ensure that investors are provided transparent and complete disclosure on the safe and sound use of resources by the SAC, we propose in § 630.20(n) that Funding Corporation resources used by the SAC be disclosed by category in the annual report to investors. The proposed categories would include, at a minimum, independent legal counsel and related services, consultants, actuaries, outside advisors and other services performed on behalf of the SAC. We propose that fees paid for the audit of the combined System-wide financial statements and any fees under $5,000 per category need not be disclosed. In addition to disclosing the name of SAC members, we propose that experience and compensation for each member be included in the annual report. We propose this change for consistency with audit committee disclosures required at the bank and association level.

IV. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FCA hereby certifies that the proposed rule would not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, Farm Credit System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

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[1] Pub. L. 92-181, 85 Stat. 583 (1971), 12 U.S.C. 2001 et seq.

[2] 12 U.S.C. 2252(a)(8), (9) and (10).

[3] 71 FR 5740 (Feb. 2, 2006).

[4]Section 620.6 of the FCA's regulations states, "[e]ach member of an audit committee must be a member of the Farm Credit institution's board of directors . . . All committee members should be knowledgeable in at least one of the following: public and corporate finance, financial reporting and disclosure, or accounting procedures."

[5]75 FR 70619 (Nov. 18, 2010).

List of Subjects in 12 CFR Part 630

Accounting, Agriculture, Banks, banking, Organization and functions (Government agencies), Reporting and recordkeeping requirements, Rural areas.

For the reasons stated in the preamble, part 630 of chapter VI, title 12 of the Code of Federal Regulations are proposed to be amended as follows:

PART 630—DISCLOSURE TO INVESTORS IN SYSTEM-WIDE AND CONSOLIDATED BANK DEBT OBLIGATIONS OF THE FARM CREDIT SYSTEM

1. The authority citation for part 630 is revised to read as follows:

Authority: Secs. 4.2, 4.9, 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2153, 2160, 2243, 2252, 2254); sec. 424 of Pub. L. 100-233, 101 Stat. 1568, 1656; sec. 514 of Pub. L. 102-552, 106 Stat. 4102.

Subpart A--General

2. Section 630.6 is amended by revising paragraphs (a)(3) and (a)(4)(ii)(A) to read as follows:

§ 630.6 Funding Corporation committees.

(a) *System Audit Committee.* *** * ***

*** * * * ***

(3) *Resources.* The Funding Corporation must provide the SAC monetary and nonmonetary resources the SAC determines necessary to enable it to perform the duties listed in paragraph (a)(4) of this section. The Funding Corporation must permit the SAC to contract, for reasons directly related to the duties listed in paragraph (a)(4), the services of external auditors, independent legal counsel, and outside advisors. The SAC must not use the resources of the Funding Corporation in a manner that would adversely affect the safety and soundness of the System or be contrary to law and regulation. The SAC must provide the Funding Corporation board of directors a quarterly accounting of expenditures made pursuant to this section.

(4) *Duties.* *** * ***

*** * * * ***

(ii) *External auditors* . The external auditor must report directly to the SAC. The SAC must:

(A) Determine, with the agreement of the Funding Corporation board of directors, the appointment, compensation, and retention of the external auditors issuing System-wide audit reports;

*** * * * ***

Subpart B--Annual Report to Investors

3. Section 630.20 is amended by revising paragraph (n) to read as follows:

§ 630.20 Contents of the annual report to investors.

*** * * * ***

(n) *System Audit Committee.* The Funding Corporation must include in the System-wide Report to Investors a description of the System Audit Committee and its activities during the reporting period. At a minimum, the report must:

(1) List the names of the System Audit Committee members, including each member's term of office and principal occupation during the past 5 years. For each member, state the total cash and noncash compensation paid for services on the System Audit Committee during the reporting period.

(2) Categorize and disclose the dollar value of monetary and nonmonetary resources used by the System Audit Committee during the reporting period. Describe the benefit(s) obtained from expenditures made under each category. Disclosures of fees paid for the audit of the System-wide financial statements and those categories of expenses having an annual aggregate dollar value of less than $5,000 are not required. At a minimum, there must be separate categories for:

(i) Administrative expenses,

(ii) Contracted legal services,

(iii) Contracted consultants and advisors, and

(iv) Other contracted services, identifying the services.

*** * * * ***

Date: February 9, 2012

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.

75 FR 27951, 05/19/2010

Handbook Mailing HM-10-5

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 652

RIN 3052-AC56

Federal Agricultural Mortgage Corporation Funding and Fiscal Affairs; Farmer Mac Investments and Liquidity

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking (ANPRM).

SUMMARY: The Farm Credit Administration (FCA, Agency, us, or we) is considering amending our regulations governing the Federal Agricultural Mortgage Corporation (Farmer Mac or the Corporation) non-program investments and liquidity requirements. The objective of these regulations is to ensure that Farmer Mac holds an appropriate level of high-quality, liquid investments to maintain a sufficient liquidity reserve, invest surplus funds, and manage interest rate risk.

DATES: You may send us comments by July 6, 2010.

ADDRESSES: We offer a variety of methods for you to submit comments on this advanced notice of proposed rulemaking. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the Agency's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4056;

or

Jennifer A. Cohn, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objective

The objective of this ANPRM is to solicit public comments on revisions and updates to Farmer Mac's non-program investment and liquidity management regulations in light of investment and liquidity risk issues that arose during the recent financial crisis. With the benefit of information gained through this ANPRM and our internal analysis, we will consider changes to the regulations to enhance their fundamental objective: to ensure the safety and soundness and continuity of Farmer Mac operations.

II. Background

Congress established Farmer Mac in 1988 as part of its effort to resolve the agricultural crisis of the 1980s. Congress expected that establishing a secondary market for agricultural and rural housing mortgages would increase the availability of competitively priced mortgage credit to America's farmers, ranchers, and rural homeowners.

In addition to serving its investor-stakeholders, Farmer Mac, like all Government-sponsored enterprises (GSEs), has a public policy purpose embedded in its corporate mission that arises from having been created by an act of Congress. The public policy component of its mission explicitly includes its service to customer-stakeholders (farmers, ranchers, rural homeowners, and rural utility cooperatives, all through their lenders).[1] The public policy component also includes protection of taxpayer-stakeholders. The latter arises from Farmer Mac's ability to issue debt to the Department of the Treasury to cover guarantee losses under certain circumstances.[2] These two public policy components of Farmer Mac's mission are, in some respects, counterbalancing, as we now explain.

A fundamental premise of finance is the natural positive relationship between risk and expected return. This means that when Farmer Mac increases its expected return, it also increases its risk of loss; the opposite is true when risk decreases. More return, in general, will better position Farmer Mac to reduce the rates it charges customers (a benefit to those stakeholders) and increase its earnings (a benefit to investor-stakeholders). However, the risk Farmer Mac assumes to earn a greater return increases the risk to others, including ultimately taxpayers, and thus adds an offsetting cost to these earnings benefits.

In general, a guiding principle for FCA in establishing regulations is to maintain an appropriate balance between these costs and benefits, i.e., attempting to maximize Farmer Mac's ability to serve its customers and provide an appropriate return for investors while ensuring that it engages in safe and sound operations, thereby providing a high degree of certainty that Farmer Mac will continue to be able to make its products available to serve customers and will never need to issue debt to the Department of Treasury.

Liquidity is a firm's ability to meet its obligations as they come due without substantial negative impact on its operations or financial condition. While the management of Farmer Mac's non-program investment portfolio and its liquidity risk are closely linked, they are not synonymous. Management of the non-program investment portfolio, and specifically the associated market risk, is one component under the general heading of liquidity risk management. Liquidity risk is the risk that the Corporation is unable to meet expected obligations (and reasonably estimated unexpected obligations) as they come due without substantial adverse impact on its operations or financial condition. Reasonably estimated liquidity risk should consider scenarios of debt market disruptions, asset market disruptions such as industry sector security price risk scenarios, as well as contingent liquidity events. Contingent liquidity events include significant changes in overall economic conditions, or events that would impact the market's perception of Farmer Mac such as reputation risks and legal risks, as well as a broad and significant deterioration in the agriculture sector and its potential impact on Farmer Mac's need for cash to fulfill obligations under the terms of products such as Long-Term Standby Purchase commitments.

Farmer Mac's primary sources of liquidity are the principal and interest it receives from non-program and program investments and its access to debt markets. The sale of non-program investments – which consist of investment securities, cash, and cash equivalents -- provides a secondary source of liquidity cushion in the event of a short-term disruption in Farmer Mac's access to the capital markets that prevents Farmer Mac from issuing new debt. The sale of Farmer Mac's program investments in agricultural mortgages, rural home loans, and rural utility cooperative loans could provide additional liquidity, although the amount of liquidity provided by these instruments in times of stress is uncertain. The reason for that uncertainty is that, with the exception of the subset of these investments that are guaranteed by the United States Department of Agriculture (USDA),[3] we are not aware of significantly active markets in which to sell them. As a result, FCA regulations do not currently recognize any liquidity value in Farmer Mac's program book of business (with the exception of a discounted amount of the Farmer Mac II volume).

During 2008, the markets in corporate debt and asset-backed securities experienced significant value reductions in response to the general seizing up of these markets. For financial regulators, these events highlighted the need to reevaluate the requirements for liquidity risk management. This experience also has triggered broad re-evaluation of liquidity risk management among institutions and regulators globally -- including a re-evaluation of the degree of confidence that is assumed in corporate policies and regulatory guidance regarding the availability of markets for debt issuance and asset sales under stressful economic or market conditions. We are interested in public response to questions regarding FCA regulatory requirements related to Farmer Mac’s management of market risk, liquidity risk, and funding risk.

III. Section-by-Section Questions for Public Comment

A discussion of our existing regulations (which became effective in the third quarter of 2005), along with our questions about changes we are considering to these regulations, follow. For ease of use, Section IV., at the end of this document, lists the key questions asked throughout this section.

A. Section 652.10--Investment Management and Requirements

Effective risk management requires financial institutions to establish: (1) policies; (2) risk limits; (3) mechanisms for identifying, measuring, and reporting risk exposures; and (4) strong corporate governance including specific procedures and internal controls. Section 652.10 requires Farmer Mac to establish and follow certain fundamental practices to effectively manage risks in its investment portfolio.

This provision requires Farmer Mac's board of directors to adopt written policies that establish risk limits and guide the decisions of investment managers. Board policies must establish objective criteria so investment managers can prudently manage credit, market, liquidity, and operational risks. Investment policies must provide for specific risk limits and diversification requirements for the various classes of eligible investments and for the entire investment portfolio. Risk limits must be based on Farmer Mac's business mix, capital position, the term structure of its debt, the cash flow attributes of both on- and off-balance sheet obligations and risk tolerance capabilities. Risk tolerance can be expressed through several parameters such as duration, convexity, sector distribution, yield curve distribution, term structure of debt, credit quality, risk-adjusted return, portfolio size, total return volatility, or value-at-risk.[4] Farmer Mac must use a combination of parameters to appropriately limit its exposure to credit and market risk. The policies must also establish other controls--such as delegation of responsibilities, separation of duties, timely and effective valuation practices, and routine reporting--that are consistent with sound business practices.

1. Earnings Performance and Risk Benchmarks

We have questions regarding several areas of § 652.10. Our first general area of discussion pertaining to this section concerns the usefulness of adding regulatory guidance to benchmark earnings performance and risk profiles of the investment portfolio to evaluate liquidity risk and non-program investment management. Section 652.10(c) requires Farmer Mac's board to establish investment risk limits, and § 652.10(g) requires Farmer Mac's management to report to the board on investment performance and risk. The regulation does not, however, include specific requirements regarding acceptable levels of either earnings performance (such as the spread over cost of funds or the spread over an appropriate yield benchmark) or risk (such as measured by historical variation of returns or as implied by changes in earnings levels).

Risk is measured in terms of the uncertainty (i.e., volatility) of the expected earnings stream. Inferences about real-time changes in risk can be drawn from the real-time changes in prices, i.e., the yield the market demands on the instruments at any point in time. An increase in return demanded by investors implies greater risk. In this discussion, we use return measurements as a proxy for relative risk measurements.

Earnings spreads are performance indicators with implications regarding relative risk. For example, in times of market turbulence, investors may prefer debt issued by Farmer Mac simply because it is GSE debt – a "flight to quality" – and not because of any positive developments in Farmer Mac's business. With its debt in greater demand, its cost of funds would decrease. The coupon interest Farmer Mac receives on its investments would continue at its previous level.[5] The result would be a widening in the spread between Farmer Mac's earnings rates and its cost of funds. Would this scenario clearly imply an increase in Farmer Mac's liquidity risk?

To ensure an appropriate level of earnings performance while limiting risk to an acceptable level, should our regulations (and/or Farmer Mac board policy) specify earnings performance benchmarks and some acceptable band of earnings performance above and below such benchmarks? The benchmark could be used to evaluate investment portfolio earnings and risk. Earnings performance that is too low compared to the benchmark would indicate a need for improved management of earnings performance, and earnings performance that is too high indicating unacceptable levels of liquidity risk, or credit risk, or both? A detailed explanation and more detailed questions follow.

Investor behavior is an indicator of relative risk in the market. For purposes of this explanation, we divide the universe of investors into two general categories by risk tolerance--either risk-seeking or risk-averse. In periods of "flight to quality," two changes occur in investor behavior relative to the pre-turbulence baseline: (1) risk-seeking investors demand higher yields (and theoretically the increase is specifically higher liquidity premium or credit premium, or both)[6] and (2) risk-averse investors accept lower yields from perceived higher-quality issuers. In periods of "flight to quality," interest rates on non-GSE debt securities would tend to move up, while interest rates on GSE debt would tend to move down. For Farmer Mac, this has two implications: (1) its cost of funds declines; and (2) the liquidity risk in its non-program investments increases. The latter occurs because the market's view of the relative liquidity and credit strength of marketable securities has deteriorated – which is why investments purchased in a more normal environment would then sell at discount to par in order to provide risk-seeking investors with the increased liquidity/credit premiums they require.[7]

The market's perception of liquidity and credit quality constantly fluctuates. Therefore, a key question is: is there some level of increased earnings spread (relative to an appropriate spread benchmark) that could reasonably be assumed to indicate an unacceptable amount of increased liquidity risk? We do not believe that an institution should be penalized for a decline in the liquidity of what had previously been acceptable investments due to events over which it had no influence. However, should the regulations (or board policy) recognize the reduced liquidity in the investment portfolio and guide management's response to steer the institution back toward a more acceptable level of liquidity risk? ***If so, how might Farmer Mac's liquidity management policy establish limits around an investment portfolio benchmark, either statically or dynamically, to reflect the potential changes in investment value that can occur in stressful market or economic environments?***

There may be market-based measures such as spreads (and the amount of time over which unusually wide or narrow spreads are sustained) that would be more dynamic indicators of liquidity risk and enhance the recognition of, and response to, significantly increased risks through discounting procedures that are indexed to major changes in such indicators. Dynamic indicators could be included in Farmer Mac board policy and, when exceeded, simply instruct management to steer the portfolio back toward the targeted indicator level over some period of time. From a conceptual perspective, a dynamic indicator showing an unusually wide spread may indicate increased risk in the liquidity value of the investment portfolio. Further, an unusual degree of narrowing of spreads (that occurs despite no change in Farmer Mac's financial position) may indicate reduced risk in the liquidity value of the investment portfolio. Therefore, a dynamic indicator based on earnings spreads of eligible securities might be used to establish limits that would trigger a rebalancing of the investment portfolio. This rebalancing would help ensure that the portfolio maintains stability in market value even under stressful conditions.[8]

We recognize that one possible complicating factor to such spread limits might be the inability in some cases to clearly identify the underlying funding instruments (and therefore the costs) of a given subset of Farmer Mac's investments. Therefore, return levels (i.e., yields) might offer another indication of relative risk. Yield thresholds might be an alternative for a dynamic threshold to help ensure that portfolio liquidity risk does not exceed acceptable levels. For example, would it be appropriate for Farmer Mac to set triggers based on weighted-average yield thresholds set at some level above a benchmark eligible investment portfolio return--which, when triggered, would require management to rebalance the investment portfolio (or asset class within the portfolio)?

2. Contingency Liquidity Funding Plan

Our second area of discussion pertaining to this regulation concerns § 652.10(c)(3). That provision requires that Farmer Mac's investment policies describe the liquidity characteristics of eligible investments that it will hold to meet its liquidity needs and objectives, but it does not require liquidity contingency funding planning. Such plans are generally regarded as a key component of good corporate governance, and Farmer Mac currently has a contingency funding plan in place. ***Would it be appropriate for our regulations to require a liquidity contingency funding plan? If so, how specific should the regulation be regarding required components of the plan versus simply requiring that the plan reasonably reflect current standards, for example, those specified by the Basel Committee on Banking Supervision?*** [9]

3. Debt Maturity Management Plan

Third, the maturity structure of Farmer Mac's debt is a key driver of its liquidity position at any given time and a key input to the calculation of its minimum liquidity reserve requirement (discussed in Section III.B. of this preamble). Under normal yield curve conditions, long-term debt – debt maturing in greater than 1 year -- is more costly than short-term debt – debt maturing in less than 1 year. Long-term debt, however, is generally viewed as adding stability and strength to a corporation's liquidity position compared to short-term debt given the need to frequently roll over such debt.

Farmer Mac's term structure of debt, as published in its balance sheet, has normally been heavily weighted in short-term debt. Farmer Mac often synthetically extends the term of much of its short-funded debt using swap contracts, which results in a lower net cost of funds compared to simply issuing longer term debt. The fact that these combinations of debt and derivative positions behave like longer term debt contributes to the stability and strength of its liquidity position. However, the practice adds counterparty risk on the swaps and short-term debt rollover risk to Farmer Mac's overall liquidity risk position compared to issuing long-term debt.

In light of the marginal funding instability that results from relying primarily on shorter term debt – even when the maturity is extended synthetically - would it be appropriate to require Farmer Mac to establish a debt maturity management plan? If so, how might such a requirement be structured?

We recognize that the minimum daily liquidity reserve requirement includes incentives to this same end of moderating the term structure of debt. However, this question asks specifically whether this additional requirement would appropriately augment the minimum daily liquidity reserve requirement and partially compensate for some of the shortcomings of that measurement discussed in Section III.B. of this preamble.

4. Evidence of Market for Program Investments

Finally, as discussed above, we are aware of no significantly active markets in which Farmer Mac could sell its program investments held on-balance sheet (other than Farmer Mac II assets), and therefore the amount of liquidity provided by these investments is uncertain. We recognize that Farmer Mac from time to time has sold these instruments successfully in the past. Moreover, the principal and interest cash flows on these assets provide liquidity in the normal course of business. ***In light of the foregoing, should the availability of a liquid market for Farmer Mac's program investments be considered in the Corporation's liquidity contingency funding plan?*** [10]

B. Section 652.20(a)--Minimum Daily Liquidity Reserve Requirement

The minimum daily liquidity reserve requirement found at § 652.20(a) requires Farmer Mac to hold eligible liquidity instruments such as cash, eligible non-program investments, and/or Farmer Mac II assets (subject to certain discounts) to fund its operations for a minimum of 60 days.[11]

This "days-of-liquidity" metric, while useful, has drawbacks. Perhaps foremost among those drawbacks is that this metric contains information about a single point-in-time, but it provides no projected information. A large days-of-liquidity measurement today provides little or no information about what the measurement might be tomorrow.

Are there other metrics or approaches that might improve upon, augment, or appropriately replace days-of-liquidity as currently used in § 652.20(a)? For example, in the current days-of-liquidity calculation, once discounts have been applied to assets, each liquid asset dollar (net of discounts) is viewed (for purposes of the calculation) as being of equal quality and liquidity value. However, clearly there is greater liquidity value in, for example, the amount of undiscounted cash dollars in that total than there is in the dollars associated with corporate debt securities. Under the current rule, the debt securities are discounted at either 5 percent or 10 percent for purposes of estimating liquidity value, but the actual amount realized in a sale would depend on many factors. If stress developed suddenly in the market, the debt securities might be worth considerably less than the discounted amounts, but the cash dollars would not change.

Therefore, to recognize greater differences in the liquidity value of different asset classes, and to augment the minimum days-of-liquidity requirement, would it be appropriate to establish a subcategory of the minimum days-of-liquidity requirement that would include, for example, only cash or Treasury securities in the definition of "primary liquid assets" but also set a smaller minimum required number of days? Recognizing that liquidity risk cannot be eliminated for Farmer Mac, could a "primary" days-of-liquidity minimum add significant certainty to Farmer Mac's liquidity policies at an acceptable cost? We recognize that the return on such investments is likely to be lower than Farmer Mac's funding costs, which would create a drag on earnings. ***If such a requirement is warranted, what would be the appropriate number of minimum primary days-of-liquidity, balancing the benefits gained from maintaining these higher quality liquid assets against their higher cost?***

C. Section 652.20(c)--Discounts

Section 652.20(c) requires Farmer Mac to apply specified discounts to all investments in the liquidity portfolio, other than cash and overnight investments, in order to reflect the risk of diminished marketability of even these liquid investments under adverse market conditions. The investments that must be discounted include money market instruments, floating and fixed rate debt and preferred stock securities, diversified investment funds, and Farmer Mac II assets. In the wake of the recent disruptions in financial markets, we are considering whether a more conservative view of the discounts is appropriate.

At the same time, we recognize that deep discounts, if actually realized during a liquidation, impact not only Farmer Mac's ability to meet obligations in a timely manner, but also its capital position. In other words, the loss on sale of these assets at extremely deep discounts could, at large volumes, have a very detrimental impact on capital levels.

Thus, in setting this policy, there is a trade-off between setting deeper, more conservative discounts versus the alternative of excluding those assets from eligibility (or, in the case of Farmer Mac II assets, excluding them from the liquidity reserve) because appropriately deep discounts might reasonably be so deep that, if realized, they could destabilize Farmer Mac's capital position. ***In light of these concerns, would it be appropriate to re-evaluate the discounts in § 652.20(c) to better reflect the risk of***

diminished marketability of liquid investments under adverse conditions? If so, which ones and what would be the appropriate degree of change? In particular, we request public comment on whether the discount currently applied on Farmer Mac II securities is appropriate.

In addition, the existing, relatively coarse discounting schedule could overlook important liquidity-quality characteristics of individual investments. ***Would it be appropriate to refine the schedule of discounts in § 652.20(c)? For example, there is no difference in the discounts applied to AAA-rated versus AA-rated corporate debt securities.*** Conversely, is the coarseness of the current discount schedule more desirable because of its simplicity?

D. Section 652.35(a)--Eligible Non-Program Investments

The current rule provides Farmer Mac with a broad array of eligible high-quality, liquid investments while providing a regulatory framework that can readily accommodate innovations in financial products and analytical tools.

Farmer Mac may purchase and hold the eligible non-program investments listed in § 652.35 to maintain liquidity reserves, manage interest rate risk, and invest surplus short-term funds. As we stated in our preamble adopting this rule, only investments that can be promptly converted into cash without significant loss are suitable for achieving these objectives.[12] We further stated our intent that all eligible investments be either traded in active and universally recognized secondary markets or valuable as collateral.[13] For many of the investments, the regulation requires that they not exceed certain maximum percentages of the total non-program investment portfolio. We established these portfolio caps to limit credit risk exposures, promote diversification, and encourage investments in securities that exhibit low levels of price volatility and liquidity risk. In addition, the table sets single obligor limits to help reduce exposure to counterparty risk.

Would the experience gained during the financial markets crisis of 2008 and 2009 justify adjustments to many of the portfolio limits in § 652.35 to add conservatism to them and improve diversification of the portfolio? We invite comments on appropriate changes for each asset class, final maturity limit, credit rating requirement, portfolio concentration limit, and other restrictions. We also request comment on several specific provisions, as follows.

1. Section 652.35(a)(1)-–Obligations of the United States

Section 652.35(a)(1) permits Farmer Mac to invest in Treasuries and other obligations (except mortgage securities) fully insured or guaranteed by the United States Government or Government agency without limitation. ***Given that Farmer Mac might not always hold the "on the run" (i.e., highest liquidity) issuance of Treasury securities, would imposing maximum maturity limitations enhance the resale value of these investments in stressful conditions?***

2. Section 652.35(a)(2)-–Obligations of Government-Sponsored Agencies

In light of the recent financial instability of Government-sponsored agencies such as Fannie Mae and Freddie Mac, would it be appropriate to revise this section to put concentration limits on exposure to these entities in § 652.35(a)(2)? [14]

3. Section 652.35(a)(3)-–Municipal Securities

Section 652.35(a)(3) authorizes investment in municipal securities. Currently, revenue bonds are limited to 15 percent or less of Farmer Mac's total investment portfolio, while general obligations have no such limitation. The maturity limits and credit rating requirements are also more generous for general obligations. ***The requirements in § 652.35(a)(3) carry the implied assumption that general obligation bonds are always less risky than revenue bonds. But is that always the case?*** In the scenario of severe economic recession, could a municipal issuer's tax base erode faster than the revenues on a bridge or toll road, for example? ***Would it be more appropriate for our regulation to limit both sub-categories equally?***

4. Section 652.35(a)(6)-–Mortgage Securities

Section 652.35(a)(6) authorizes investments in non-Government agency or Government-sponsored agency securities that comply with 15 U.S.C. 77(d)5 or 15 U.S.C. 78c(a)(41). These types of mortgage securities are typically issued by private sector entities and are mostly comprised of securities that are collateralized by "jumbo" mortgages with principal amounts that exceed the maximum limits of Fannie Mae or Freddie Mac programs. ***We invite comment on whether it is appropriate to include mortgage securities collateralized by "jumbo" mortgages as an eligible liquidity investment.***

5. Section 652.35(a)(8)-–Corporate Debt Securities

Section 652.35(a)(8) authorizes investment in corporate debt securities. The rule does not contain concentration limits related to industry sector exposure. We request comment on whether such industry sector exposure limits should be added. ***Further, is it appropriate to allow investments in subordinated debt as the current rule does? If so, is it appropriate that subordinated debt receives discounts and investment limits at the same level as more senior types of corporate debt?***

E. Section 652.35(d)(1)--Obligor Limits

An appropriate level of diversification is a key attribute of a liquidity investment portfolio. In § 652.35(d)(1), we prohibit Farmer Mac from investing more than 25 percent of its regulatory capital in eligible investments issued by any single entity, issuer, or obligor. Government-sponsored agencies have a different obligor limit; Farmer Mac may not invest more than 100 percent of its regulatory capital in any one Government-sponsored agency. There are no obligor limits for Government agencies.

Do the obligor limits in § 652.35(d)(1) generally provide for an adequate level of diversification? Specifically, in light of the uncertainty associated with the current conservatorships of both Fannie Mae and Freddie Mac, is it appropriate to maintain a higher obligor limit for Government-sponsored agencies?

F. Section 652.40--Stress Tests for Mortgage Securities

In the current rule, stress-testing requirements apply to one type of asset--mortgage securities--and one type of stress--interest rate risk.[15] ***Is the scope of the stress-testing requirement adequate, or should it be broadened to apply to the entire investment portfolio (both individually and at a portfolio level)? Should the scope of the stress-testing be expanded to include market price risks due to factors other than interest rate changes?*** We refer to both firm-specific risks and systemic risks. Firm-level risks include operational fraud, deteriorating program asset quality, and negative media coverage. Systemic risks include industry sector shocks such as occurred on September 11, 2001, with payment system disruption, or asset class as was seen in the financial services sector in 2007 and 2008. ***If the scope of required stress-testing is expanded, what types and severity of liquidity event scenarios***

should be tested, and how should forward-looking cash-flow projections be built around these scenarios?

IV. List of Key Questions

- To ensure an appropriate level of earnings performance while limiting risk to an acceptable level, should our regulations (and/or Farmer Mac board policy) specify earnings performance benchmarks and some acceptable band of earnings performance above and below such benchmarks? If so, how might Farmer Mac's liquidity management policy establish limits around an investment portfolio benchmark, either statically or dynamically, to reflect the potential changes in investment value that can occur in stressful market or economic environments?

- Would it be appropriate for our regulations to require a liquidity contingency funding plan? If so, how specific should the regulation be regarding required components of the plan versus simply requiring that the plan reasonably reflect current standards, for example, those specified by the Basel Committee on Banking Supervision?

- In light of the marginal funding instability that results from relying primarily on shorter term debt – even when the maturity is extended synthetically - would it be appropriate to require Farmer Mac to establish a debt maturity management plan? If so, how might such a requirement be structured?

- Should the availability of a liquid market for Farmer Mac's program investments be considered in the Corporation's liquidity contingency funding plan?

- Are there other metrics or approaches available that might improve upon, augment, or appropriately replace days-of-liquidity as currently used in § 652.20(a)? For example, to recognize greater differences in the liquidity value of different asset classes, and to augment the minimum days-of-liquidity requirement, would it be appropriate to establish a subcategory of the minimum days-of-liquidity requirement that would include, for example, only cash or Treasury securities in the definition of "primary liquid assets" but also set a smaller minimum required number of days? If such a requirement is warranted, what would be the appropriate number of minimum primary days-of-liquidity, balancing the benefits gained from maintaining these higher quality liquid assets against their higher cost?

- Would it be appropriate to re-evaluate the discounts in § 652.20(c) in order to better reflect the risk of diminished marketability of liquid investments under adverse conditions? If so, which ones and what would be the appropriate degree of change? In particular, we request public comment on whether the discount currently applied on Farmer Mac II securities is appropriate.
  Would it be appropriate to refine the schedule of discounts in § 652.20(c)? For example, there is no difference in the discounts applied to AAA-rated versus AA-rated corporate debt securities.

- Would the experience gained during the financial markets crisis of 2008 and 2009 justify adjustments to many of the portfolio limits in § 652.35 to add conservatism to them and improve diversification of the portfolio? We invite specific comments on appropriate changes for each asset class, final maturity limit, credit rating requirement, portfolio concentration limit, and other restrictions.

  Given that Farmer Mac might not always hold the "on the run" (i.e., highest liquidity) issuance of Treasury securities, would imposing maximum maturity limitations enhance the resale value of these investments in stressful conditions?

In light of the recent financial instability of Government-sponsored agencies such as Fannie Mae and Freddie Mac, would it be appropriate to revise this section to put concentration limits on exposure to these entities in § 652.35(a)(2)?

The requirements in § 652.35(a)(3) carry the implied assumption that general obligation bonds are always less risky than revenue bonds. But is that always the case? Would it be more appropriate for our regulation to limit both sub-categories equally?

We invite comment on whether it is appropriate to include mortgage securities collateralized by "jumbo" mortgages as an eligible liquidity investment.

Further, is it appropriate to allow investments in subordinated debt as the current rule does? If so, is it appropriate that subordinated debt receives discounts and investment limits at the same level as more senior types of corporate debt?

- Do the obligor limits in § 652.35(d)(1) generally provide for an adequate level of diversification? Specifically, in light of the uncertainty associated with the current conservatorships of both Fannie Mae and Freddie Mac, is it appropriate to maintain a higher obligor limit for Government-sponsored agencies?

- Is the scope of the stress-testing requirement adequate, or should it be broadened to apply to the entire investment portfolio (both individually and at a portfolio level)? Should the scope of the stress-testing be expanded to include market price risks due to factors other than interest rate changes? If the scope of required stress-testing is expanded, what types and severity of liquidity event scenarios should be tested, and how should forward-looking, cash flow projections be built around these scenarios?

V. Conclusion

We welcome comments on all provisions of this notice, even if we did not request specific comments on those provisions.

Dated: May 13, 2010

Roland E. Smith,
Secretary,
Farm Credit Administration Board.

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[1] *See* title VIII of the Farm Credit Act of 1971, as amended (Act), 12 U.S.C. 2279aa-2279cc *et seq.)*

[2] *See* section 8.13 of the Act.

[3] Farmer Mac's program investments in loans that are guaranteed by the USDA as described in section 8.0(9)(B) of the Act, and which are securitized by Farmer Mac, are known as the "Farmer Mac II"

program.

[4]Duration measures a bond's or portfolio's price sensitivity to a change in interest rates. Convexity measures the rate of change in duration with respect to a change in interest rates. Yield curve distribution refers to the distribution of the portfolio's investments in short-, intermediate-, or long-term investments. Term structure of debt refers to the distribution of the Corporation’s debt maturities over time. Value-at-risk is a methodology used to measure market risk in an investment portfolio.

[5]The scenario ignores interest rate effects which could influence the spread in either direction depending on the circumstances, and also the impact of any new investments over the period.

[6]Yields are generally viewed as containing four compensation components: 1) The risk-free rate (which includes a load for expected inflation), 2) credit premium over the risk-free rate, which compensates the investor for default risk, 3) liquidity premium over the risk-free rate, which compensates the investor for the risk that he will be unable to sell the investment quickly at, or near, par, and 4) premium associated with the value of embedded options (if any). For purposes of this explanation, we assume option-adjusted spreads to remove the impact on spreads of changes in the value of embedded options.

[7]Excluding Treasury and GSE investments with regard, at least, to credit risk.

[8]In addition, another scenario may be worth considering. Is there a plausible scenario under which Farmer Mac’s cost of funds would drop precipitously enough to increase earnings spreads above some wide threshold over benchmark spreads that would be due solely to positive developments in Farmer Mac’s business, and therefore have no implications on the liquidity risk of its investments?

[9]"Principles for Sound Liquidity Risk Management and Supervision", Basel Committee on Banking Supervision, Bank for International Settlements, September 2008 (or successor document, in the future). This document can be found at http://www.bis.org/publ/bcbs144.htm

[10]Section 652.10, on investment management and requirements, currently governs only non-program investment activities. This would be a new requirement governing the liquidity of Farmer Mac's program investments.

[11]The purpose of this minimum daily liquidity reserve requirement is to enable Farmer Mac to continue its operations if its access to the capital markets were impeded or otherwise disrupted.

[12]70 FR 40641 (July 14, 2005).

[13]*Id.*

[14]Under § 652.35(a)(2), Government-sponsored agency mortgage securities, but no other such securities, are limited to 50 percent of Farmer Mac’s total non-program investment portfolio. In addition, § 652.35(d)(1) bars Farmer Mac from investing more than 100 percent of its regulatory capital in any one Government-sponsored agency.

[15]By interest rate risk, we refer to the price sensitivity of mortgage instruments over different interest rate/yield curve scenarios, including prepayment and interest rate volatility assumptions – as described in current § 652.40).

76 FR 71798, 11/18/2011

Handbook Mailing HM-11-13

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 652

RIN 3052-AC56

Federal Agricultural Mortgage Corporation Funding and Fiscal Affairs; Farmer Mac Investments and Liquidity Management

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, Agency, us, or we) proposes to amend our regulations governing the Federal Agricultural Mortgage Corporation (Farmer Mac or the Corporation) in the areas of non-program investments and liquidity. We are proposing to modify the specific requirements supporting our objective to ensure that Farmer Mac maintains adequate liquidity to withstand stressful conditions in accordance with board-established risk tolerance and holds only high-quality, liquid investments in its liquidity reserve. We also propose to expand the allowable purposes of Farmer Mac's non-program investments to include investments that would add value to Farmer Mac's operations by complementing its program activities. Further, we request comments on the best approach for compliance with section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or DFA), which requires us to remove all references to and requirements relating to credit ratings and to substitute other appropriate standards of creditworthiness. Finally, we propose significant reorganizing of sections to make the flow of the issues covered more logical.

DATES: You may send us comments by January 17, 2012.

ADDRESSES: We offer a variety of methods for you to submit comments on this proposed rule. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the Agency's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Laurie A. Rea, Director, Office of Secondary Market Oversight, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4434;

or

Jennifer A. Cohn, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objective

The objective of this proposed rule is to ensure the safety and soundness and continuity of Farmer Mac operations for the purpose of furthering its public mission. To achieve this objective FCA is proposing to:

- Revise the permissible purposes of non-program investments;
- Modify the type, quality, maximum remaining term and maximum amount of non-program investments[1] that may be held by Farmer Mac;
- Strengthen diversification requirements, including portfolio limits on specific types of investments and counterparty exposure limits;
- Revise board policy and stress testing requirements;
- Modify the non-program investment portfolio limit;
- Revise the computation, and level of the minimum, liquidity reserve requirement;
- Reduce the regulatory burden associated with investments that fail to meet eligibility criteria after purchase or are otherwise unsuitable;
- Seek public input on approaches to remove reliance on credit ratings in compliance with section 939A of the Dodd-Frank Act; and
- Reorganize the regulations to make the flow of the issues covered more logical by delineating more clearly among sections governing investment management, interest rate risk management, and liquidity risk management.

II. Introduction

On May 19, 2010, we published an advance notice of proposed rulemaking (ANPRM) that considered revisions to Farmer Mac's non-program investment and liquidity requirements.[2] The 45-day comment period ended on July 6, 2010. After considering the comments we received on this ANPRM, we now propose revisions to these requirements.

III. Background

Congress established Farmer Mac in 1988 as part of its effort to resolve the agricultural crisis of the 1980s. Congress expected that establishing a secondary market for agricultural and rural housing mortgages would increase the availability of competitively priced mortgage credit to America's farmers, ranchers, and rural homeowners.

A guiding principle for FCA in establishing regulations governing Farmer Mac is to maintain an appropriate balance between the Corporation's mission achievement and risk. Specifically, the intent of this regulation is to allow Farmer Mac to sufficient flexibility to fully serve its customers and provide an appropriate return for investors while ensuring that it engages in safe and sound operations. We believe achieving an appropriate balance between mission achievement and risk should provide a high degree of certainty that Farmer Mac will continue to make its products available to serve customers without the need to issue debt to the Department of Treasury or seek any other form of government financial assistance.[3]

Existing FCA regulations currently authorize Farmer Mac to invest in non-program investments for three purposes; to manage short-term surplus funds, to comply with interest rate risk requirements, and to comply with liquidity reserve requirements.[4] Liquidity is a firm's ability to meet its obligations as they come due without substantial negative impact on its operations or financial condition. The availability of an appropriately sized portfolio comprised of highly liquid assets is necessary for the Corporation to conduct its business and to achieve its statutory purposes. Moreover, we believe that Farmer Mac's liquidity reserve portfolio, while it must be low risk, can appropriately include investments that provide a positive return on the portfolio and still fulfill the investment purposes authorized by regulation under most market conditions.

Liquidity risk is the risk that the Corporation could become unable to meet expected obligations and reasonably estimated unexpected obligations as they come due without substantial adverse impact on its operations or financial condition. Reasonably estimated liquidity risk should consider scenarios of debt market disruptions, asset market disruptions such as industry sector security price risk scenarios, and other contingent liquidity events. Contingent liquidity events include significant changes in overall economic conditions, events that would impact the market's perception of Farmer Mac (such as reputation risks and legal risks), and a broad and significant deterioration in the agriculture sector and its potential impact on Farmer Mac's need for cash to fulfill obligations under the terms of products such as Long-Term Standby Purchase Commitments and AgVantage Plus bond guarantees.

While the management of Farmer Mac's non-program investment portfolio and its liquidity risk are closely linked, they are not synonymous. Management of the non-program investment portfolio includes market risk, credit risk, and cash management, as well as earnings performance.[5] Moreover, as discussed below, we propose to permit investments that complement program activities, even if those investments may not contribute significantly to liquidity risk management. The inclusion of investments of this nature highlights the distinction between investment management and liquidity risk management.

IV. <u>General Discussion of Letters Commenting on the ANPRM</u>

We received four comment letters on the ANPRM, one each from the Farm Credit Council (Council), AgFirst Farm Credit Bank (AgFirst), Farm Credit West ACA (Farm Credit West), and Farmer Mac. We discuss in this preamble those comments that pertain to changes we are proposing or to certain provisions where we propose no changes. Some of the questions in our ANPRM, however, were very general and theoretical and discussed potential policy options that we have elected not to propose in this rulemaking. We do not discuss comments submitted in response to those questions, but we will consider them in future rulemakings as appropriate.

The Council commented generally that Farmer Mac's liquidity requirements should be commensurate with its funding risk and equivalent to the liquidity standards required for Farm Credit System (System) lenders engaged in similar activities. The Council's letter also included detailed comments to many of the specific questions raised in the ANPRM, and it identified specific instances where the Council believes the Farmer Mac regulations should be more closely aligned with those governing the System. Ag First's and Farm Credit West's letters concurred with the opinions expressed in the Council's comment letter, and Ag First's letter also included several specific comments.

In response to commenters, we agree, in general that the liquidity requirements governing Farmer Mac and the System should be consistent, and alignment is appropriate in certain areas. However, we also believe that Farmer Mac's business model, which focuses on secondary market activities (as opposed to the wholesale and retail lending models of FCS banks), combined with the other differences in their authorizing statutes, provide ample justification for differences in certain areas of their regulatory structures. We address the Council's and AgFirst's specific comments, including specific areas of alignment and differentiation, below in the section-by-section discussion.

In its comment letter, Farmer Mac agreed that the ANPRM identified important questions relating to liquidity. It believes, however, that a number of these questions relate specifically to policies and procedures that should be set at its board level. It therefore reserved specific comments until FCA issues a proposed rule, and it instead submitted two conceptual level comments for FCA's consideration.

Farmer Mac first suggested that "any proposed regulation should establish broad guidelines that lead to prudent risk management rather than being prescriptive." Farmer Mac stated that in an economic environment that could change from 1 minute to the next, its ability to respond quickly to market forces and adjust its use of a range of asset classes is critical. It expressed concern that rigid and narrow eligibility criteria and amounts for its liquidity portfolio could lead to limited options and thus result in greater concentrations of relatively higher risk asset classes or particular assets. It recognized the FCA's regulatory responsibility to ensure safety and soundness, but it believes the onus of establishing appropriate specific policies and procedures should be left to its board and management.

We agree that Farmer Mac's board of directors is ultimately accountable and responsible for effective implementation of prudent policies and practices. Nonetheless, as the Corporation's prudential regulator, we are charged with establishing an appropriate regulatory and supervisory framework to promote the long-term viability and safety and soundness of the Corporation as well as achievement of its public mission.

Farmer Mac encouraged FCA to consider the 2010 Interagency Policy Statement on Funding and Liquidity Risk Management adopted by the other Federal banking regulatory agencies.[6] Farmer Mac stated that this policy outlines a comprehensive yet flexible regulatory policy for funding and liquidity risk that promotes safety and soundness and yet allows for differences in board-approved policies across financial institutions as well as across market and economic environments. Farmer Mac further stated that regulations should allow for adherence in a variety of market situations to ensure real safety and soundness and, for this reason, regulations that establish guidelines or parameters, together with an examination process that tests board-approved policies and procedures, would be the best framework for ensuring that Farmer Mac continues to maintain adequate amounts and types of liquidity.

In response to Farmer Mac's request that FCA consider the Interagency Policy Statement, we note that there are many similarities between that Statement and this proposed rule, particularly with respect to the definition of highly liquid assets, stress testing requirements, and contingency funding plans. In addition, this proposed rule has also, where appropriate, drawn on guidance issued to international regulators by the Basel Committee on Banking Supervision (Basel Committee) on the topic of liquidity risk management.[7]

However, both the Interagency Policy Statement and the guidance issued by the Basel Committee apply to a very large and diverse group of financial institutions with wide variation in structure, size, and complexity of operations. That breadth of covered institutions necessitates that any Interagency Policy Statement providing guidance to all of them must be general in its content.

OSMO's role as regulator of one institution provides the opportunity to be more specific in its guidance. Nonetheless, we generally agree with Farmer Mac's main point to preserve as much of the flexibility embedded in the Interagency Policy Statement as is appropriate.

Farmer Mac's second conceptual level comment is that, since its liquidity portfolio will continue to be a large part of its balance sheet, any new regulatory approach should recognize the tradeoff between the need for liquidity and the need for "asset income" (i.e., earnings). Farmer Mac states that prudent business practices cannot ignore the need to provide some return on investments, given the necessary size of its portfolio. Farmer Mac believes the need for return on its investments is even more critical because of the statutory requirements that it hold minimum capital of 275 basis points against the investments.[8] Farmer Mac asserted the importance of balancing the costs of "a strong liquidity position with the economic interests of Farmer Mac's customers and other stakeholders that serve rural America." Farmer Mac suggests this need for regulatory balance is even more critical in volatile financial markets, when asset prices or expected returns can change suddenly. The Corporation further states that regulations that establish "guidelines" rather than prescriptive "narrow targets or asset classes" would provide Farmer Mac the flexibility to respond appropriately to volatile markets and "prudently reduce risk by adjusting policies and changing the asset mix to eliminate illiquid assets, while maintaining an appropriate return." Farmer Mac asserts that ultimately, this will lead to the safest and most liquid portfolio possible.

In response to this point, we agree that our regulations should recognize the tradeoff between the need for liquidity and the need for a reasonable return on assets. This concept is central to this rulemaking and we discussed the policy implications of the risk and return tradeoff in detail in the ANPRM.[9] There, we noted that the balance we target in the revised regulations is intended to serve all Farmer Mac stakeholders, who include not only customers who serve the financing needs of rural America and investors who require a return on investment, but also taxpayers. Liquidity risk management is a specified purpose of the non-program investment portfolio. Income, while acceptable within a reasonable range, is not a purpose of the non-program investment portfolio. Accordingly, our guiding principle is that high liquidity attributes must generally take precedence over earnings generation in Farmer Mac's non-program investment portfolio.

V. Section-by-Section Discussion of Proposed Revisions

We propose to reorganize the rule considerably and provide the following table to orient the reader to the proposed reorganization. The left column of the table contains the existing rule's section headings and the right column contains the proposed reorganization of section sequence and heading changes.

Existing Regulations	Proposed Reorganization

§ 652.1 Purpose.	§ 652.1 Purpose
§ 652.5 Definitions.	§ 652.5 Definitions.
§ 652.10 Investment management and requirements.	§ 652.10 Investment management.
§ 652.15 Interest rate risk management and requirements.	§ 652.15 Non-program investment purposes and limitation.
§ 652.20 Liquidity reserve management and requirements.	§ 652.20 Eligible non-program investments.
§ 652.25 Non-program investment purposes and limitation.	§ 652.25 Management of ineligible and unsuitable investments.
§ 652.30 Temporary regulatory waivers or modifications for extraordinary situations.	§ 652.30 Interest rate risk management.
§ 652.35 Eligible non-program investments.	§ 652.35 Liquidity management.
§ 652.40 Stress tests for mortgage securities.	§ 652.40 Liquidity reserve requirement and supplemental liquidity.
§ 652.45 Divestiture of ineligible non-program investments.	§ 652.45 Temporary regulatory waivers or modifications for extraordinary situations.

We will address each section below in the order it appears in these proposed regulations and discuss, where applicable, the rationale for the reorganization. Generally, the proposed reorganization is meant to address sequentially as completely as possible the three major categories of management governed in the rule: investment management; interest rate risk management; and liquidity management.

Throughout this regulation, we propose minor technical, clarifying, and non-substantive language changes that we do not specifically discuss in this preamble.

A. Section 652.1--Purpose

We propose to delete the first sentence of this section as unnecessary. There is no need to list the topics of the subpart.

B. Section 652.5--Definitions

To enhance clarity of the rule, we propose to add a definition of "cash" to mean cash balances held at Federal Reserve Banks, proceeds from traded-but-not-yet-settled debt, and the insured amount of balances held in deposit accounts at Federal Deposit Insurance Corporation-insured banks.

We also propose to add definitions for two newly proposed planning requirements, the Liability Maturity Management Plan and the Contingency Funding Plan, which are discussed below in the discussion of § 652.35.

We propose to delete the definition of "liquid investments," as well as the definition of "marketable" in current § 652.20(c), and to replace those terms with a description of the term "highly marketable" in § 652.40(c). This term is addressed in the discussion of that section.

We propose to add a definition of "liquidity reserve." This new definition is described in the discussion of proposed § 652.40.

Finally, we are proposing several technical changes. We propose to correct an erroneous regulatory reference in the definition of *affiliate*. We propose to clarify the definitions of *FCA*, *Government agency*, and *Government-sponsored agency*. And we define *OSMO* to mean FCA's Office of Secondary Market Oversight.

C. Section 652.10--Investment Management

Section 652.10 would continue to require Farmer Mac to establish and follow certain fundamental practices to effectively manage risks in its investment portfolio. The recent crisis and its lingering effects have re-emphasized the importance of sound investment management, and we believe that strengthened regulation would further insure the safe and sound management of investments. Accordingly, we are proposing the revisions discussed herein. In addition, we propose minor technical, clarifying, and non-substantive language changes to this section that we do not specifically discuss in this preamble.

We propose to revise the section heading to delete "and requirements" as it should be understood that the regulations contain requirements.

1. Section 652.10(a)--Responsibilities of the Board of Directors

In § 652.10(a), we propose to add the requirement that the Farmer Mac board of directors affirmatively validate the sufficiency of investment policies to ensure the board's full and in-depth understanding of, and control over, the policies.

2. Section 652.10(b)-–Investment Policies – General Requirements

Section 652.10(b) lists the items that the board's investment policy must address, and it includes every requirement of § 652.10. Because we propose to change some of those requirements, we also propose to change the listing, to clarify our expectations as to the appropriate content of the board's policies. We discuss below the requirements we propose to revise.

In addition, we propose to move existing § 652.10(c)(2), which requires that Farmer Mac's records or minutes must document any analyses used in formulating policies or amendments of policies, to § 652.10(b). With this move, this requirement would no longer be limited to policies governing market risk; it would apply to all investment management policies.

3. Section 652.10(c)-–Investment Policies – Risk Tolerance

Our proposed changes in this section add greater specificity to our expectations regarding our existing requirements. These proposed changes are intended to provide clarity to our expectations but are not intended to fundamentally change the requirements.

Proposed § 652.10(c)(1) requires Farmer Mac's investment policies to establish risk limits for credit risk. Policies would have to include credit quality standards, limits on counterparty risk, and risk diversification standards that appropriately limit concentrations based on geographical area, industry sectors, or asset classes or obligations with similar characteristics. Policies would also have to address management of relationship brokers, dealers and investment bankers, as well as collateral management related to margin requirements on repurchase agreements.

Proposed § 652.10(c)(2) requires Farmer Mac's investment policies to establish risk limits for market risk as the value of its holdings may decline in response to changes in interest rates or market conditions. Exposure to market risk is measured by assessing the effect of changing rates and prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire Corporation.

4. Section 652.10(e)-–Internal Controls

In § 652.10(e)(2), we propose adding to the list of personnel whose duties and supervision must be separated from personnel who execute investment transactions. These additional personnel are those who post accounting entries, reconcile trade confirmations, and report compliance with investment policy. We believe this additional separation is a best practice that Farmer Mac must have in place to ensure controls are sufficient and appropriate.

In § 652.10(e)(4), we propose to require Farmer Mac to implement an effective internal audit program to review, at least annually, its investment controls, processes, and compliance with FCA regulations and other regulatory guidance. The internal audit program would specifically have to include a review of Farmer Mac's process for ensuring all investments are eligible and suitable for purchase under its board's investment policies. We believe this requirement provides important guidance on Agency expectations regarding internal oversight of these operations.

5. Section 652.10(f)-–Due Diligence

Proposed § 652.10(f) would cover the pre-purchase analysis, ongoing value determination, quarterly stress testing, and pre-sale value verification that Farmer Mac must perform on each non-program investment that it purchases. This provision would combine in one location requirements that are now primarily in existing § 652.10(f) and § 652.40 and in other provisions as well. It would also contain a more detailed description of the due diligence procedures that are required for investments, but we do not intend to change the fundamental intent of the provision.

a. Section 652.10(f)(1)––Pre-Purchase Analysis

Proposed § 652.10(f)(1) would require Farmer Mac to satisfy certain requirements for each investment that it wishes to purchase. Proposed § 652.10(f)(1)(i) sets forth pre-purchase requirements regarding the objective, eligibility, and suitability of investments. This provision would require Farmer Mac, before it purchases an investment, to document the Corporation's investment objective.[10]

Proposed § 652.10(f)(1)(i) would also require Farmer Mac to conduct sufficient due diligence to determine whether the investment is eligible under § 652.35 and suitable under its board-approved investment policies and to document the investment's eligibility and suitability. "Suitability" is a term that is new to our regulations. A non-program investment is "suitable" if it is eligible under § 652.35(a) and conforms to Farmer Mac board policy. A non-program investment is unsuitable if it is eligible but does not conform to Farmer Mac board policy.

Finally, proposed § 652.10(f)(1)(i) would require Farmer Mac's investment policies to fully address the extent of pre-purchase analysis that management must perform for various types, classes, and structure of investments.

In proposed § 652.10(f)(1)(ii), we would retain from existing § 652.10(f)(1) the requirement that prior to purchase, Farmer Mac must verify the value of an investment (unless it is a new issue) with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction.

In proposed § 652.10(f)(1)(iii), we would require Farmer Mac to document its risk assessment of each investment, including, at a minimum, an evaluation of credit risk, market risk, and liquidity risk. In its evaluation of credit risk, § 652.10(f)(1)(iii)(A) would require Farmer Mac to consider, as applicable, the nature and type of underlying collateral, credit enhancements, complexity of the structure, and any other available indicators of the risk of default.

In its evaluation of market risk, § 652.10(f)(1)(iii)(B) would require Farmer Mac to consider how various market stress scenarios including, at a minimum, potential changes in interest rates and market conditions (such as changes in market perceptions of creditworthiness), are likely to affect the cash flow and price of the instrument, using reasonable and appropriate methodologies for stress testing for the type or class of instrument to ensure the investment complies with risk limits established in its investment and interest rate risk policies.

We note that in our existing regulations, the pre-purchase stress testing requirement is combined with a quarterly portfolio stress testing requirement in § 652.40, which is a standalone stress testing regulation. With the intent of improving the organization of the regulations, we have moved the pre-purchase and quarterly stress testing requirements into the paragraph covering due diligence in our investment management regulation (§ 652.10) and have separated the two stress tests in that paragraph to make clearer the difference in stress tests to evaluate individual securities prior to purchase and quarterly stress tests conducted on the investment portfolio.[11]

Existing § 652.40 imposes stress testing requirements only on mortgage securities and requires consideration of interest rate risk scenarios only. The pre-purchase stress testing requirements in proposed § 652.10(f)(1)(iii)(B) would apply to all non-program investments, including Treasury securities, and they would more broadly include market stress scenarios such as changes in market conditions, including market perceptions of creditworthiness, as well as stressed interest rate scenarios. We believe that all investments must be stress tested to provide for a comprehensive and internally consistent analytical framework from which to evaluate the risks in the investment portfolio. In addition, we believe that a broader consideration of changes in market conditions is necessary because of the potential for a direct impact on liquidity of adverse changes in those conditions.

In its response to a question in our ANPRM about stress testing, the Council stated that stress testing should be an integral part of managing liquidity and that regulatory requirements should focus on requiring entities to regularly test various stress scenarios unique to their own balance sheet and potential liabilities. The Council further stated that an institution with a relatively low level of liquidity risk might appropriately accept relatively more risk in its liquidity portfolio, while the opposite might be true for an institution with more liquidity risk. We agree generally with these statements and consider them to be generally consistent with our proposals in the area of stress testing.

In its evaluation of liquidity risk, § 652.10(f)(1)(iii)(C) would require Farmer Mac to consider the investment structure, the depth of the market, and Farmer Mac's ability to liquidate the position under a variety of economic scenarios and market conditions.

b. <u>Section 652.10(f)(2)—Ongoing Value Determination</u>

Proposed § 652.10(f)(2) retains the requirement from the existing provision that at least monthly, Farmer Mac must determine the fair market value of each investment in its non-program investment portfolio and the fair market value of its entire non-program investment portfolio.

c. <u>Section 652.10(f)(3)—Quarterly Stress Testing</u>

As discussed above, we propose moving our non-program investment quarterly stress-testing requirements into § 652.10(f)(3), as part of our due diligence requirements, and removing existing § 652.40 as a standalone stress testing regulation. As with the pre-purchase stress testing discussed above, the proposed rule would impose the quarterly stress testing requirement on all non-program investments, including Treasury securities.

Existing § 652.40 is limited to interest rate stress scenarios. Proposed § 652.10(f)(3)(ii) recognizes that there are stress scenarios other than interest rate risk that could also impact the value or marketability of investments including, at a minimum, changes in market conditions (including market perceptions of creditworthiness).

The revisions would also include a change to the requirement that all stress testing assumptions be supported by verifiable information; we propose to qualify this requirement with "to the maximum extent practicable" to recognize that modeling treatments could require assumptions for which insufficient supporting data or information exists, thus requiring management to apply reasonable judgment. Moreover, Farmer Mac would be required to document the basis for all assumptions used.

6. <u>Section 652.10(g)—Reports to the Board of Directors</u>

We propose revisions to § 652.10(g), which specifies information that executive management must report to the board or a board committee each quarter. The requirements would be fundamentally unchanged but the language would be modified to add clarifying detail to FCA expectations. The following would have to be reported:

- Plans and strategies for achieving the board's objective for the investment portfolio;
- Whether the investment portfolio effectively achieves the board's objectives;
- The current composition, quality, and liquidity profile of the investment portfolio;
- The performance of each class of investments and the entire investment portfolio, including all gains and losses incurred during the quarter on individual securities sold before maturity and why they were liquidated;
- Potential risk exposure to changes in market interest rates as identified through quarterly stress testing and any other factors that may affect the value of the investment holdings;
- How investments affect Farmer Mac's capital, earnings, and overall financial condition; and
- Any deviations from the board's policies. These deviations must be formally approved by the board of directors.

D. <u>Section 652.15--Non-Program Investment Purposes and Limitation</u>

We propose to renumber existing § 652.25 as § 652.15. We propose in paragraph (a) to add a new permissible purpose for non-program investments -- investments that complement program business activities. This purpose would recognize that certain investments, such as investments with a rural focus that are backed by the full faith and credit of the United States Government, could advance Farmer Mac's mission. This provision would not add any new eligible investments to our authorized list; Farmer Mac would still need to seek FCA's prior approval for any investments not explicitly authorized on the list of eligible investments.

Section 8.3(c)(12) of the Act permits Farmer Mac to "purchase or sell any securities or obligations . . . necessary and convenient to the business of the Corporation." We believe this proposed broadening of investment purposes is compatible with Farmer Mac's statutory mandate and consistent with congressional intent.

Neither the proposed purpose nor any of the three existing purposes authorize Farmer Mac to accumulate investment portfolios for arbitrage activities or 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 specified permissible investment purposes. Farmer Mac must ensure that its internal controls, required under § 652.10(e), ensure that eligible investments purchased under § 652.20(a) clearly fulfill one or more of the purposes authorized under § 652.15(a).

In addition, we propose to change the current regulatory maximum non-program investment parameters in paragraph (b) to delete the alternate maximum of a fixed $1.5 billion. While we continue to believe that excessive or inappropriate use of non-program investments is not consistent with the Corporation's statutory mission and status as a Government-sponsored enterprise (GSE), we believe the maximum investment parameter of 35 percent of program volume alone is sufficient and that there is no longer a need for the $1.5 billion ceiling on that maximum calculation. This proposed change is based on Farmer Mac's growth since the $1.5 billion ceiling was established in 2005.

We also propose to permit Farmer Mac to exclude investments pledged to meet margin requirements for derivative transactions (collateral) when calculating the 35-percent investment limit under paragraph (b).[12] We note that investments that are pledged as collateral do not count toward Farmer Mac's compliance with its liquidity reserve requirement.[13] We propose this change because the Dodd-Frank Act may result in additional margin requirements for Farmer Mac and we do not want to discourage the use of derivatives as an appropriate risk management tool.

E. Section 652.20--Eligible Non-Program Investments

Under the current rule, Farmer Mac may purchase and hold the eligible non-program investments listed in § 652.35(a). This list permits Farmer Mac to invest, within limits, in an array of highly liquid investments while providing a regulatory framework that can readily accommodate innovations in financial products and analytical tools.

The recent financial crisis resulted in substantial turmoil in the financial markets. Based on this experience, we now propose amendments that would clarify the characteristics of eligible investments, eliminate certain investments, and reduce portfolio limits where appropriate. In addition, we ask questions about the most effective way to comply with section 939A of the DFA. As discussed in greater detail below, that provision requires each Federal agency to revise all regulations that refer to or require reliance on credit ratings to assess creditworthiness of an instrument to remove the reference or requirement and to substitute other appropriate creditworthiness standards. We also propose to renumber this regulation as § 652.20.

1. Section 652.20(a)

We propose revisions to the language in the introductory paragraph of paragraph (a). The existing language authorizes Farmer Mac to hold only the types, quantities, and qualities of investments that are listed. Like our existing regulation, our proposal would permit institutions to purchase only those investments that satisfy the eligibility criteria in § 652.35 (which would be renumbered as § 652.20). An investment that does not satisfy the eligibility criteria would not be eligible for purchase and would be subject to the divestiture requirements of proposed § 652.25(a) if it were purchased.[14]

In a change from our existing approach, however, eligibility would be determined only at the time of purchase. An investment that satisfies the eligibility criteria at the time of purchase but that subsequently failed to satisfy the eligibility criteria would not become ineligible and would not have to be divested. Instead, Farmer Mac would be permitted to retain the investment subject to certain requirements. As discussed below, in our discussion of our proposed amendments to § 652.25, we believe this change would reduce regulatory burden without creating safety and soundness concerns.

In addition, existing § 652.35(a) states that all investments must be denominated in United States dollars. We propose to relocate this language to paragraph (b) of redesignated § 652.20.

The table in § 652.35(a) currently provides that a specified nationally recognized statistical rating organizations (NRSRO) credit rating is a criterion for eligibility for a number of asset classes, including municipal securities, money market instruments, mortgage securities, asset-backed securities, and corporate debt securities. Section 939A of the Dodd-Frank Act requires us to remove this criterion and to substitute other appropriate creditworthiness standards. Below, we discuss possible approaches as to how we can comply with this requirement. We do not propose any revisions to this criterion at this time.

Finally, we discuss general comments on the table, received in response to the ANPRM. In the ANPRM, we asked, “Would the experience gained during the financial markets crisis of 2008 and 2009 justify adjustments to many of the portfolio limits in § 652.35 to add conservatism to them and improve diversification of the portfolio?" We also invited comment on appropriate changes within each asset class regarding final maturity limit, credit rating requirement, portfolio concentration limit, and other restrictions.

The Council suggested making "limited changes" to the portfolio limits, stating that the financial markets, and specifically the market for mortgage securities, have arguably suffered through severe crisis and System entities have emerged in a solid financial position. The Council believes that existing limits, particularly on non-Agency mortgage securities, arguably prevented System entities from focusing on higher return sectors that would have resulted in larger losses. The Council suggested that the Farmer Mac regulations should be "closely aligned with existing limits for other Farm Credit entities."

In our discussion below, we discuss the revisions we propose by eligible asset class, and we respond to the Council's general comments above as well as their specific comments on particular asset classes.

a. Section 652.20(a)(1)--Obligations of the United States

Existing § 652.35(a)(1)(which would become § 652.20(a)(1)) permits Farmer Mac to invest in Treasuries and other obligations (except mortgage securities) fully insured or guaranteed by the United States Government or a Government agency without limitation.[15] We note that Ginnie Mae securities fall under this provision.

In the ANPRM, we asked, "Given that Farmer Mac might not always hold the 'on the run' (i.e., highest liquidity) issuance of Treasury securities, would imposing maximum maturity limitations enhance the resale value of these investments in stressful conditions?" In its comments, the Council stated that "Treasury securities with longer dated maturities have the potential to provide less liquidity due to sensitivities to changes in interest rates."

We propose no change to this regulation. Although we agree with the Council that the value of longer term Treasuries can vary due to interest rate risk, we deal with interest rate risk in a separate section of these regulations. In this section, our concern is focused on differences in liquidity due to differences in trading volume and bid/ask spreads between on-the-run and off-the-run Treasury securities.

b. Section 652.20(a)(2)--Obligations of Government-Sponsored Agencies

Existing § 652.35(a)(2)(which would become § 652.20(a)(2)) permits Farmer Mac to invest in obligations of Government-sponsored agencies,[16] including Government-sponsored agency securities and other obligations fully insured or guaranteed by Government-sponsored agencies (but not mortgage securities). The only limitation currently imposed on these non-mortgage security investments is found in § 652.35(d)(1), which precludes Farmer Mac from investing more than 100 percent of its regulatory capital in any one Government-sponsored agency.[17]

In the ANPRM we asked, "In light of the recent financial instability of Government-sponsored agencies such as Fannie Mae and Freddie Mac, would it be appropriate to revise this section to put concentration limits on exposure to these entities in § 652.35(a)(2)?" The Council stated that it is appropriate to maintain portfolio limits on securities issued by the Federal National Mortgage Corporation (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and even Government National Mortgage Corporation (Ginnie Mae) securities, which enjoy explicit government backing. The Council noted that the Federal government is currently contemplating regulatory GSE reform through the legislative process in this area.

We do not propose concentration limits on exposures to Government-sponsored agencies based on historical experience, including that observed in recent years, that the value of GSE debt has not declined materially even when the GSE has been under significant stress.

Our proposal would limit investments in Government-sponsored agency obligations to senior debt securities. We believe counterparty exposures to Government-sponsored agencies should be confined only to the highest quality investments and should not include subordinated debt or hybrid equity issuances.

c. Section 652.20(a)(3)--Municipal Securities

Existing § 652.35(a)(3) (which would become § 652.20(a)(3)) authorizes investments in municipal securities. Currently, revenue bonds are limited to 15 percent or less of Farmer Mac's total investment portfolio, while general obligations have no such limitations. The maturity limit is also longer for general obligations.

In the ANPRM we asked whether it would be "more appropriate for our regulation to limit both sub-categories [of municipal securities] equally?" The Council stated that historically, general obligation bonds have been less risky than revenue bonds because of the taxing authority of the underlying issuer but also stated that in the recent economic downturn, the safety of many of these general obligation issues have been called into question due to the financial strains on many State and local governments. Accordingly, the Council commented that all municipal securities should carry similar limits.

We agree. We also believe, in light of the ongoing financial strain at the municipal level, that additional limitations on municipal securities, whether general obligations or revenue bonds, are warranted. Accordingly, we propose to authorize investment in municipal securities only if the securities have a maximum remaining maturity of 10 years or less at the time of purchase and the investments do not exceed 15 percent of the total non-program investment portfolio.

d. Section 652.20(a)(4)--International and Multilateral Development Bank Obligations

Section 652.35(a)(4) (which would become § 652.20(a)(4)) currently authorizes investments in obligations of international and multilateral development banks, provided the United States is a voting shareholder. Examples of eligible banks include the International Bank for Reconstruction and Development (World Bank), Inter-American Development Bank, and the North American Development Bank. Other highly rated banks working in concert with the World Bank to promote development in various countries are also eligible, subject to the shareholder-voting requirement above. There is no maturity limit or portfolio limit.

We propose to revise this provision to authorize investment in such obligations with similar constraints as those applied to municipal securities. The nature of the obligations in this asset class is similar to municipal obligations in that the ultimate creditors are a diverse group of governments with varying credit characteristics. While we view this asset class as generally strong credits, we do not believe its strength is equivalent to U.S. Treasuries, and therefore some limits are appropriate. On that basis, we propose a 10-year limit on their maximum maturity remaining at purchase and a portfolio concentration limit of 15 percent of Farmer Mac's total non-program investment portfolio.

e. Section 652.20(a)(5)—Money Market Instruments

Existing § 652.35(a)(5) (which would become § 652.20(a)(5)) permits institutions to invest in repurchase agreements that satisfy specified conditions. If the counterparty defaults, the regulation requires the institution to divest non-eligible securities in accordance with the divestiture requirements of § 652.45. Under our proposal, as discussed above, an eligible investment could not become ineligible, and would not be required to be divested. Accordingly, we propose to delete this divestiture requirement.

f. <u>Section 652.20(a)(6)--Mortgage Securities</u>

Existing § 652.35(a)(6) (which would become § 652.20(a)(6)) requires stress testing of all mortgage securities. As discussed above, proposed § 652.10(f) would require stress testing on all investments held in Farmer Mac's portfolio. Accordingly, we propose to delete the specific stress-testing requirement for mortgage securities.

The first asset class listed in existing § 652.25(a)(6) is mortgage securities that are issued or guaranteed by the United States or a Government agency. We propose to revise this asset class description to refer to mortgage securities that are fully guaranteed or fully insured by a Government agency. The deletion of "United States" is a technical, non-substantive change, because we propose to include "United States" in the definition of "Government agency" in § 652.5. The addition of the word "fully" makes clear that this asset class includes only mortgage securities that are fully backed by the full faith and credit of the United States. If the United States Government issues a mortgage security that is not fully guaranteed or fully insured by the full faith and credit of the United States Government, it is not eligible under this asset class.

The third asset class listed in existing § 652.35(a)(6) authorizes investments in non-Government agency or Government-sponsored agency securities that comply with 15 U.S.C. 77d(5) or 15 U.S.C. 78c(8)(41). These types of mortgage securities are typically issued by private sector entities and are mostly comprised of securities that are collateralized by “jumbo” mortgages with principal amounts that exceed the maximum limits of Fannie Mae or Freddie Mac programs. We propose technical, non-substantive changes to the language describing this asset class, for clarity. Furthermore, in this preamble we refer to these securities using the shorthand reference non-Agency mortgage securities.

In the ANPRM, we invited comment on whether it is appropriate to continue to include non-Agency mortgage securities collateralized by "jumbo" mortgages as an eligible liquidity investment. The Council commented that while these are not as liquid as agency collateralized mortgage obligations, and despite the fact that this sector is currently under stress, it believes the sector can provide viable diversification and should develop stronger credit quality over time with improved underwriting and increased credit enhancements. We do not propose to remove this asset class from the list of eligible investments at this time, but we will continue to evaluate the appropriateness of including this asset class.

However, to reduce credit default risk that may be associated with certain positions in non-Agency mortgage securities, we propose to require that a position in such a security would be eligible only if it is the senior-most position at the time of purchase. The FCA considers a position in a non-Agency mortgage security to be the senior-most position only if it currently meets both of the following criteria:

- No other remaining position in the securitization has priority in liquidation. Remaining positions that are the last to experience losses in the event of default and which share those losses pro rata meet this criterion.
- No other remaining position in the securitization has a higher priority claim to any contractual cash flows. Remaining positions that have the first priority claim to contractual

cash flows (including planned amortization classes), as well as those that share on a pro rata basis a first priority claim to cash flows meet this criterion.

The tranche that is the senior-most position at the time Farmer Mac is considering purchase is not necessarily the same tranche that was in the senior-most position at the time of issue. Farmer Mac should be careful not to be misled by the labeling of tranches as "super senior" or "senior" in a prospectus (or on market reporting services). Farmer Mac may purchase non-Agency mortgage-backed securities (MBS) only if the securities satisfy the above two criteria at the time of purchase.

Further, the existing rule's concentration limit for non-Agency mortgage securities is 15 percent when combined with another asset class -– commercial mortgage-backed securities. However, because of our belief that commercial mortgage-backed securities pose undue risk due to the nature of the underlying collateral and the particularly weak performance of this asset class during the financial crisis, we propose to delete these securities as an eligible asset class. Given the existing rule's combined portfolio concentration limit of 15 percent for these two asset classes, we propose to set the portfolio concentration limit for non-Agency securities at 10 percent.

g. <u>Section 652.20(a)(7)--Asset-Backed Securities</u>

Existing § 652.35(a)(7) (which would become § 652.20(a)(7)) authorizes Farmer Mac to invest in asset-backed securities (ABS) secured by credit card receivables; automobile loans; home equity loans; wholesale automobile dealer loans; student loans; equipment loans; and manufactured loans. The maximum weighted average life (WAL)[18] for fixed rate or floating rate ABS at their contractual interest rate caps is 5 years, and all ABS combined are limited to 25 percent of Farmer Mac's non-program investment portfolio.

In its comment letter, AgFirst noted that the existing 25-percent portfolio limit is higher than the 20 percent permitted for other System institutions.[19] AgFirst stated that there should be movement toward consistency. AgFirst further stated that ABS suffered from severe market deterioration during the recent credit crisis and that bringing the limit down to that in place for other System institutions would help reduce concentration risk.

Because we agree with AgFirst's comment, and because of the relative lack of liquidity of all ABS in the wake of the recent financial crisis, we propose to reduce the portfolio limit to no more than 15 percent (combined) of Farmer Mac's total investment portfolio and to limit any single collateral type to no more than 5 percent.[20] In addition, given the significant instability in the ABS market in recent years, we propose a maximum WAL of 7 years for floating rate ABS with current coupon rates below their contractual interest rate cap.

h. <u>Section 652.20(a)(8)--Corporate Debt Securities</u>

Existing § 652.35(a)(8) (which would become § 652.20(a)(8)) authorizes investment in corporate debt securities, limited to 25 percent of Farmer Mac's total non-program investment portfolio. In its comment letter, AgFirst noted that the existing limit is higher than the 20 percent permitted for other System institutions.[21] AgFirst stated that there should be movement toward consistency. AgFirst further stated that corporate debt securities suffered from severe market deterioration during the recent credit crisis and that bringing the limit down to that in place for other System institutions would help reduce concentration risk.

Because we agree with this comment, we propose to reduce the portfolio limit to 20 percent in total. In addition, we propose to limit corporate debt securities in any one of the industry sectors defined by the Global Industry Classification Standard (GICS) to no more than 10 percent of Farmer Mac's total investment portfolio.[22] While financial services sector was not the only industry sector hit hard by the recent financial crisis, there were sectors, e.g., utilities, that were not as severely impacted. Sector diversification limits provide enhanced guidance regarding the Agency's expectations for portfolio diversification.

In the ANPRM, we asked whether is it appropriate to allow investments in subordinated debt as the current rule does. The Council stated it does not think subordinated debt is an appropriate investment for purposes of liquidity. It based its comment on lack of liquid markets for subordinated debt as well as the lack of expertise in most financial institutions to research and evaluate the risk of individual issuers.

We generally agree with this comment and propose to limit eligible corporate debt securities to senior debt securities only. We note that, while we do not deem perfect consistency with regulations governing other System institutions to be appropriate in all cases, all of our proposed changes to investment in corporate debt securities are consistent with those recently proposed for other System institutions.[23]

i. Section 652.20(a)(9)--Diversified Investment Funds

Existing § 652.35(a)(9) (which would become § 652.20(a)(9)) authorizes investment in diversified investment funds with the stipulation that the funds' holdings must consist solely of eligible investments as defined by this section of the rule. The existing rule contains no portfolio concentration limit so long as the shares in each investment company comprise less than 10 percent of Farmer Mac's portfolio. If the shares comprise more than 10 percent, the fund's holdings are counted toward the limits for each asset class set forth in this section.

Under the existing rule, Farmer Mac could invest 100 percent of its non-program investment portfolio in 10 different funds. We believe this would not allow for sufficient diversification of the portfolio. Therefore, we propose to add a portfolio concentration limit with two components; no more than 50 percent of the total portfolio could be comprised of diversified investment funds and no more than 10 percent of the total portfolio could be in any single fund.

In addition, we believe that in the existing rule the term "diversified investment funds" could be interpreted to include closed-end funds, which are typically exchange-traded. We propose to add language stating that only open-end funds are eligible, in order to reduce the possibility that investments are purchased for potentially speculative purposes.

2. Dodd-Frank Act Compliance

In July 2010, the President signed into law the Dodd-Frank Act to strengthen regulation of the financial industry in the wake of the financial crisis that unfolded in 2007 and 2008. Section 939A of the DFA requires the following:

- Each Federal agency must review (i) all of its regulations that require the use of an assessment of the creditworthiness of a security or money market instrument, and (ii) any references to or requirements in its regulations regarding credit ratings.
- Each Federal agency must modify its regulations to remove any reference to or requirement of reliance on credit ratings and to substitute in the regulations such standards of creditworthiness as the agency determines is appropriate. In making this

determination, the agency must seek to establish, to the extent feasible, uniform standards of creditworthiness.

We have completed our review of FCA regulations that impose creditworthiness requirements or that refer to or require the use of credit ratings. Existing § 652.35 is one such regulation; it requires minimum NRSRO credit ratings for many categories of investments – including municipal securities, certain money market instruments, non-Agency mortgage securities, asset-backed securities, and corporate debt securities -- for them to be eligible.

We do not propose a method to replace NRSRO credit ratings in this rulemaking while we continue to focus our research on appropriate alternatives to them. We note that FCA has already published an ANPRM soliciting public input on the requirements of section 939A as it applies to the Agency's Risk-Based Capital Stress Test (RBCST) which sets regulatory minimum capital requirements for Farmer Mac.[24] FCA has also published a Notice of Proposed Rulemaking seeking comments on how section 939A should be applied to the eligibility regulation governing other System institutions[25] -- a regulation that is very similar to this one. Moreover, several other Federal regulators have also issued ANPRMs on this topic.[26]

In the discussion below, we explore various approaches that could be considered for assessing creditworthiness as a determinant of eligibility.[27] We may want to propose several of these approaches in concert with one another.

First, our regulation could specify financial measurements, benchmark indexes, and other measurable criteria against which institutions could evaluate the creditworthiness of their investments. For example, the regulation might specify certain ranges within the total range of those measurements to stratify or rank relative levels of creditworthiness using labels such "Highest" and "Second Highest" – and establish the level within that ranking below which investments would be deemed insufficiently creditworthy for investment by Farmer Mac. Farmer Mac would need to ensure that these criteria were met for an investment to be eligible at the time of purchase and continue to satisfy the eligibility requirements and otherwise remain a suitable investment over the period it is held. Some of the factors that could be considered in establishing these criteria are as follows:

- Credit spreads (i.e., whether it is possible to demonstrate that a position in certain investments is subject to a minimal amount of credit risk based on the spread between the security's yield and the yield of Treasury or other securities, or based on credit default swap spreads that reference the security);
- Default statistics (i.e., whether providers of credit information relating to securities express a view that specific securities have a probability of default consistent with other securities with a minimal amount of credit risk);
- Inclusion on an index (i.e., whether a security or issuer of the security is commonly included as a component of a recognized index of instruments that are subject to a minimal amount of credit risk or are deemed by FCA to be sufficiently comparable to securities on an index based on specific criteria);
- Priorities and enhancements (i.e., the extent to which a security includes credit enhancement features, along with an evaluation of the relative strength of the enhancements, such as overcollateralization and reserve accounts, or has priority under applicable bankruptcy or creditors' rights provisions);
- Price, yield and/or volume (i.e., whether the price and yield of a security or a credit default swap that references the security are consistent with other securities that are subject to a minimal amount of credit risk and whether the price resulted from active trading); and

- Asset class-specific factors (e.g., in the case of structured finance products, the risk characteristics of the specific underlying collateral).

Should FCA consider any of the above as useful sources from which to derive evaluative criteria that could replace NRSRO credit ratings? Are there other sources of information that should be included? More specifically, should the creditworthiness standard include specific standards for probability of default (PD) and loss given default (loss severity)? If so, why, and where could the agency source such data to derive such probabilities and loss severity standards? Also, should this vary by asset class and/or type of investment? Finally, would it be appropriate to combine this approach with one or more of the other approaches discussed below, and if so, which ones, and why?

As a second alternative (or in combination with the first approach), our regulation could require Farmer Mac to develop its own internal assessment process or system for evaluating the creditworthiness of investments. One way to structure such a system could be to quantify expected loss rates and stratify creditworthiness categories by range of expected loss. This would require Farmer Mac to provide convincing evidence that probability of default and loss given default estimates are reasonably accurate. Any such internal evaluation system might need to be frequently recalibrated based on changes in the marketplace.

Is this second approach -- an FCA-approved internal Farmer Mac system -- one that we should consider? If so, what principles should be applied in creating such a system, and why? Would the amount of resources needed to establish and maintain such a system potentially be overly burdensome to Farmer Mac? Would it be appropriate to combine this approach with one or more of the other approaches and if so, which ones, and why?

As a third alternative, FCA could develop regulations that would require Farmer Mac to use third party assessments to assess creditworthiness. Organizations other than NRSROs may have the capability to evaluate creditworthiness, and this evaluation could be considered in Farmer Mac's creditworthiness assessment. We also believe that the DFA does not prohibit Farmer Mac from looking to the NRSROs as a tool for assessing creditworthiness. If Farmer Mac does so, however, it should evaluate the quality of third party assessments, including consideration of whether issuers or investors pay the rating fees. In either case, as we have seen in the recent crisis, reliance on third party analysis can be problematic and cannot be used in isolation. Accordingly, if we were to require this approach, it would be in concert with one or more of the other approaches.

Is this third-party approach one that we should consider? What reliable third party sources exist? Should we distinguish between issuer-paid third party sources and investor-paid third party sources and, if so, how? How might we combine this approach with one or more of the other approaches to create an optimal regulatory structure?

Unlike the proposed regulations governing the RBCST,[28] this proposal's system of ranking investment creditworthiness need not be quantified in terms of specific expected loss rates. However, since a ranking based on expected loss rates could become available as a result of the rulemaking associated with the RBCST, we note that this system might also be applicable for purposes of these regulations governing liquidity and investment management. Moreover, if it were, it would add consistency to our regulations which, while not a necessity, is highly desirable.

3. <u>Changes to Remainder of § 652.20</u>

a. <u>Section 652.20(b)-–Dollar Denomination</u>

As discussed above, we propose to relocate to paragraph (b) the requirement, currently contained in the introductory paragraph of § 652.35(a), that all investments must be denominated in United States dollars.

b. Section 652.20(d)--Obligor Limits

We have discussed the risks of investment concentrations and the benefits of a well-diversified and high quality investment portfolio. In § 652.35(d)(1) of the existing rule, we prohibit Farmer Mac from investing more than 25 percent of its regulatory capital in eligible investments issued by any single entity, issuer, or obligor. However, the obligor limit does not currently apply to Government agencies or Government-sponsored agencies. Instead, we currently prohibit Farmer Mac from investing more than 100 percent of its regulatory capital in any one Government-sponsored agency. There are no obligor limits for Government agencies.

In the ANPRM we asked whether the obligor limits provide for an adequate level of diversification and specifically whether, in light of the uncertainty associated with the current conservatorships of both Fannie Mae and Freddie Mac, it is appropriate to maintain a higher obligor limit for Government-sponsored agencies.

Both the Council and AgFirst stated that for obligors other than Government agencies or Government-sponsored agencies, obligor limits should be reduced to 20 percent of total capital to be consistent with the limits on other System institutions. In a recent NPRM governing the other System institutions, FCA proposed that these obligor limits should be reduced from 20 percent to 15 percent.[29] We agree that consistency with other System institutions is appropriate in this case. We also believe 15 percent would help to ensure sufficient diversification among obligors. Accordingly, we propose to reduce the current obligor limit for non-Government agencies and non-Government-sponsored agency obligors from 25 percent to 15 percent of regulatory capital.

For Government-sponsored agencies, the Council stated that investment limits should be set at 50 percent of the total portfolio, in alignment with the limits placed on the System. The Council stated that the government support recently provided to Fannie Mae and Freddie Mac is very similar to that which would be provided to a government agency and that, because of the importance to the Federal government of the role filled by Fannie Mae and Freddie Mac, it appears this strong support will continue. The Council states that if future legislation weakens the “implicit” guarantee, the investment limits can be revisited at that time. The Council also stated that restrictions on Fannie Mae and Freddie Mac securities under regulatory liquidity requirements may cause institutions to take additional prepayment and extension risk in return for lower spreads by forcing the institutions to purchase Ginnie Mae securities, which have weaker cashflow stability and lower spreads as compared to similar Fannie Mae and Freddie Mac securities.

While we may not agree with every detail of the supporting justification of the Council's position, we agree that our existing 50-percent investment portfolio limit for Government-sponsored agency mortgage securities in existing § 652.35(a)(6) is appropriate, and we propose no change to that limit.

In addition, we believe that that obligor limits for obligations that are issued or guaranteed as to principal and interest by Government-sponsored agencies are not warranted due to the relatively low credit risk of Fannie Mae and Freddie Mac mortgage securities. Accordingly, we propose to delete the prohibition on Farmer Mac's investment of more than 100 percent of its regulatory capital in any one Government-sponsored agency.[30]

c. Section 652.20(e)--Other Investments Approved by FCA

Under the current regulation at § 652.35(e), with our prior written approval, Farmer Mac may purchase non-program investments in preferred stock issued by other System institutions and in other non-program investments that are not listed in § 652.35(a). We propose to revise paragraph (e) to require prior FCA approval for all investments not listed in paragraph (a), with no separate mention of FCS preferred stock. As the safety and soundness regulator for Farmer Mac, we have concerns regarding concentration and systemic risk that arise from Farmer Mac investments in large amounts of preferred stock issued by System institutions, and Farmer Mac should not expect that we will approve such investments without a compelling reason.

No change is proposed from the existing rule's requirement that Farmer Mac's request for FCA approval to invest in other non-program investments must explain the risk characteristics of the investment and the Corporation's purpose and objective for making the investment. If we approve the investment, we would notify Farmer Mac of any conditions we would impose, as well as the appropriate discount on any such investments for purposes of complying with minimum liquidity standards set forth in proposed § 652.40.

F. Section 652.40--Stress Tests for Mortgage Securities

Because we propose to relocate our stress-testing requirements to § 652.10(f), we also propose to remove this standalone, stress-testing section from our regulations.

G. Section 652.25--Management of Ineligible and Unsuitable Investments

We propose to delete existing § 652.45, which is labeled "Divestiture of Ineligible Non-Program Investments," and to replace it with § 652.25, which would be labeled "Management of Ineligible and Unsuitable Investments."

Existing § 652.45(a)(2) requires Farmer Mac to dispose of an investment that is ineligible (under the existing § 652.35 criteria) within 6 months unless we approve, in writing, a plan that authorizes divestment over a longer period of time. An acceptable divestiture plan generally must require Farmer Mac to dispose of the ineligible investment as quickly as possible without substantial financial loss. Until it actually disposes of the ineligible investment, Farmer Mac must report on specified matters to its board of directors and to FCA at least quarterly.[31]

As part of effective risk management of investments, we expect the Corporation to exit its position or develop a strategy to reduce risk exposure stemming from investments that were eligible at purchase but are no longer suitable. As part of its risk management process we would expect Farmer Mac to evaluate the potential for additional unrealized losses or write-downs under expected and stressed conditions. The risk management process for investments should be dynamic and robust. Thus, we are modifying our approach to ensure the Corporation has sufficient flexibility to manage its position and mitigate losses which may not necessarily be achieved through a forced divesture during a specific time period.

Accordingly, proposed § 652.25(b) would no longer require Farmer Mac, for an investment that satisfied the eligibility criteria set forth in § 652.20 (renumbered from § 652.35) when purchased but that no longer satisfies them,[32] to divest of the investment within 6 months unless FCA approves a divesture plan authorizing a longer divestiture period. Rather, Farmer Mac would be required to notify the OSMO promptly, and the investment would be subject to specified requirements that are discussed below. These requirements would also apply to investments that become ineligible as result of changes to the investment eligibility regulations proposed herein.

Section 652.25(b) would also require prompt notification to the OSMO when an investment that satisfies the § 652.20(a) eligibility criteria is not suitable because it does not satisfy the risk tolerance established in the institution's board policy pursuant to § 652.10(c), and the investment would be subject to the same specified requirements discussed below.

Proposed § 652.25(a) provides that an investment that does not satisfy the § 652.20 eligibility criteria at the time of purchase is ineligible. Under the proposal (as under the existing regulation), Farmer Mac may not purchase ineligible investments. If Farmer Mac did purchase an ineligible investment, it would be required to notify us promptly and to divest of the investment no later than 60 days after discovering that the investment is ineligible unless we approved, in writing, a plan that authorized divestiture over a longer period of time.[33]

Although it is not stated in the regulation, we clarify here that an acceptable divestiture plan would have to require Farmer Mac to dispose of the investment as quickly as possible without substantial financial loss. The plan would also have to contain sufficient analysis to support continued retention of the investment, including its impact on the institution's capital, earnings, liquidity, and collateral position. Our decision would not be based solely on financial loss and would include consideration of whether the investment was purchased by mistake or through the deliberate action of a Farmer Mac employee. Until Farmer Mac divested of the investment, it would be subject to the same specified requirements discussed below.

Furthermore, we emphasize that any purchase of an ineligible investment would indicate weaknesses in Farmer Mac's internal controls and due diligence and would trigger increased FCA oversight if it occurs. We expect such a purchase to occur extremely rarely, if ever.

The specified requirements that would apply to investments retained by Farmer Mac that are ineligible, that no longer satisfy the eligibility requirements, or that are unsuitable are specified in § 652.25(c). We believe these specified requirements are warranted by safety and soundness concerns.

Proposed § 652.25(c)(1) contains reporting requirements. Each quarter, Farmer Mac would be required to report to FCA and to its board on the status of all such investments. The report would have to demonstrate that impact that the investments may have on the Corporation's capital, earnings, and liquidity position. Additionally, the report would have to address how the Corporation planned to reduce its risk exposure from these investments or exit the position.

Proposed § 652.25(c)(2) contains other proposed requirements. We propose that the investments may not be used to fund Farmer Mac's liquidity reserve or supplemental liquidity required under § 652.40 and that they must continue to be included in the investment portfolio limit established in § 652.15(b).

Finally, proposed § 652.25(d) would reserve FCA's authority to require Farmer Mac to divest of any investment at any time for safety and soundness purposes. The timeframe FCA sets would consider the expected loss on the transaction (or transactions) and the impact on Farmer Mac's financial condition and performance. Because the proposed rule would not require divestiture of any investment that was eligible when purchased, FCA must reserve the authority to require divestiture of investments when necessary.

H. <u>Section 652.30--Interest Rate Risk Management</u>

We propose to reorganize the rule by moving provisions governing “Interest Rate Risk Management and Requirements” found in the existing rule at § 652.15 to new § 652.30. We propose to revise the name of this section by deleting “and requirements” because the words are unnecessary since all sections of the regulation either define or describe requirements. This same deletion and reasoning is proposed to several other section headings.

In this section, we propose in paragraph (a) two minor syntactical changes without any resulting substantive change. We propose to delete existing paragraph (b), which provides that Farmer Mac's management must ensure that interest rate risk is properly managed on both a long-range and a day-to-day basis, because we establish the ultimate responsibility for interest rate risk management at the board level in paragraph (a) and we believe it should be understood that the board would delegate proper interest rate risk management to management.

In paragraph (c)(2), we propose to require that the interest rate risk management policy identify the causes of interest rate risk and set appropriate quantitative limits consistent with a clearly articulated board risk tolerance. We believe this improves the clarity of requirements for board policy as compared with the existing corresponding regulation, at § 615.15(d)(2), which requires the policy to identify and analyze the cause of interest rate risks within Farmer Mac's existing balance sheet structure.
In paragraph (c)(3), we propose to replace the word “shock” with “stress” to make it consistent with stress testing terminology used throughout this subpart and to remove any uncertainty about whether we intend interest rate stress testing to be somehow fundamentally different from other stress testing referred to in this subpart –- we do not. In other words, board policies and risk tolerance thresholds for interest rate risk should be generally consistent with the levels applied to stress testing policies referenced in other sections of this subpart.

We further propose in this paragraph to enhance guidance on stress testing of interest rate risk by specifying that the results of stress tests must gauge the sensitivity of capital, earnings, and liquidity to interest rate stress scenarios. We further propose to specify that the methodology applied must be appropriate for the complexity of the structure and cash flows of the instruments held.

We also propose to require interest rate risk management policies to consider the nature and purpose of derivative contracts and establish counterparty concentration limits for derivatives. We propose this change in furtherance of the emphasis on derivatives counterparty risk management in Title VII of the Dodd-Frank Act and due to the significant use of derivatives by Farmer Mac to modify synthetically the term structure of its debt.

As with our quarterly stress testing requirement under § 650.10(f)(3), we propose to require that all assumptions applied in this stress test rely, to the maximum extent practicable, on verifiable information, in recognition that modeling treatments could require assumptions for which insufficient data or information exists. In addition, Farmer Mac would be required to document the basis for all assumptions.

We propose to clarify in proposed paragraphs (d)(4) and (d)(5) the appropriate roles of the board and of management.

We propose to delete existing paragraph (d)(5) because we propose to require Farmer Mac to document its objective when purchasing eligible investments in § 652.10(f)(1) of this subpart. We believe the placement of this requirement is more logical in that section.

Given that proposed deletion, we propose to re-number all paragraphs that follow in the existing § 652.15 accordingly with minor clarifying changes to their wording.

I. Section 652.35--Liquidity Management

As part of the proposed re-ordering of sections in this subpart, we propose to move and rename existing § 652.20 "Liquidity Reserve Management and Requirements" to § 652.35 "Liquidity Management."

We also propose to reorganize the rule by moving provisions governing the minimum liquidity requirements found at existing § 652.20(a) to a new section, § 652.40, to be named "Liquidity Reserve Requirement and Supplemental Liquidity."

1. Section 652.35(a)-–Liquidity Policy – Board Responsibilities

We propose to begin this section with paragraph (a) "Liquidity Policy – Board Responsibilities" (currently found at § 652.20(d)). We propose only minor revisions to that paragraph, none of which are substantive. One of these revisions is a proposed requirement that Farmer Mac's liquidity policy must be consistent with its investment management policies, including the level of the board's risk tolerance in these areas.

2. Section 652.35(b)-–Policy Content

We propose to renumber existing § 652.20(e) as § 652.35(b). We propose to change the section heading from "Liquidity Reserve Policy Content" to "Policy Content" and to make several minor syntactical changes. We also propose to add paragraph (b)(10), a liability maturity management plan (LMMP), and paragraph (b)(11), a contingency funding plan (CFP). The rationale and expectations for the LMMP and CFP proposals are explained in detail in the discussions of § 652.35(d) and § 652.35(e), respectively, below.

3. Section 652.35(c)-–Reporting Requirements

Newly proposed paragraphs (c)(1)(i) and (c)(1)(ii) of § 652.35 contain, with some minor revisions, the Farmer Mac periodic and special board reporting requirements currently found at paragraphs (f) and (g), respectively, of § 652.20(f). Newly proposed § 652.35(c)(2) contains the FCA special reporting requirement currently found at § 652.20(g).

4. Section 652.35(d)-–Liability Maturity Management Plan

In the ANPRM, we asked if it would be appropriate to require Farmer Mac to establish a debt maturity management plan. The question was whether such a plan would be appropriate in light of the marginal funding instability that results from relying primarily on shorter term debt –- even when the maturity is extended synthetically. Farmer Mac often synthetically extends the term of much of its short-funded debt using swap contracts, which results in a lower net cost of funds compared to simply issuing longer term debt (under normal yield curve conditions, as discussed in the ANPRM). The fact that these combinations of debt and derivative positions behave like longer term debt contributes to the stability and strength of its liquidity position. However, the practice adds counterparty risk on the swaps and short-term debt rollover risk to Farmer Mac's overall liquidity risk position compared to issuing long-term debt.

The minimum days-of-liquidity reserve requirement also includes incentives to this same end of diversifying the term structure of Farmer Mac's debt. This additional planning requirement would augment the days-of-liquidity measurement and reinforces the importance of management of the term structure of debt and other obligations as a key component of the liquidity risk management.[34]

The Council commented supportively, stating that each institution should have a funding strategy that provides for effective diversification of sources and tenors of funding and that maturity concentrations increase liquidity risk.

Because we agree that Farmer Mac should have such a funding strategy, we now propose a new paragraph § 652.35(d), which would require Farmer Mac's board to adopt a liability maturity management plan (LMMP) that establishes a funding strategy that provides for effective diversification of the sources and tenors of funding.[35]

This proposed § 652.35(d) sets forth specific contents and internal controls to be included in the LMMP. Under the proposal, the LMMP must:

- Include targets of acceptable ranges of the proportion of debt issuances maturing within specific time intervals;
- Reflect the Farmer Mac board's liquidity risk tolerance;[36] and
- Consider components of the Corporation's funding strategy that offset or contribute to liquidity risk associated with debt maturity concentrations.

The LMMP is intended to become a risk management tool that contributes to the management of, for example, targets for the term structure of debt. As the portion of total debt maturing within some appropriate short-term time interval increases, the amount of liquidity stress that would be experienced under a scenario of a disruption in Farmer Mac's access to debt markets (i.e., refunding risk) would likely also increase. We would expect the LMMP to place appropriate limits on that risk consistent with the board's risk tolerance level as defined in other areas of investment and liquidity risk management.

We propose to refer to this plan as an LMMP rather than as a debt maturity management plan, as we discussed in the ANPRM, to make it more general, in contemplation of the possibility that Farmer Mac could use funding instruments that might not strictly take the form of debt. For example, the LMMP would have to address the use of swaps to synthetically extend debt tenors to offset liquidity risk. However, the LMMP would also have to recognize that the counterparty risk added through those swap positions contributes to liquidity risk due to the exposure to defaults of these counterparties generally (in terms of reduced expected cash inflows) as well as through the concentration of swap exposure to individual swap counterparties. The LMMP should also consider the potential expense (and even the potential infeasibility in certain scenarios) of replacing defaulted swap positions under stressful market conditions. Finally, if overall funding strategy also includes additional swap positions that synthetically shorten the effective maturity of debt positions, these positions and counterparty exposures too would have to be reflected in the LMMP.

5. <u>Section 652.35(e)-–Contingency Funding Plan</u>

In the ANPRM, we asked whether it would be appropriate for our regulations to require a liquidity contingency funding plan (CFP). If so, we asked how specific the regulation should be regarding required components of the plan versus simply requiring that the plan reasonably reflect current standards, for example, those specified by the Basel Committee on Banking Supervision.[37]

The Council commented in support of such a requirement, stating that each institution should maintain, regularly update, and test a formal liquidity contingency funding plan that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. The Council stated that such a plan should delineate policies to manage a range of stress environments, establish clear lines of responsibility, and articulate clear implementation and escalation procedures. Further, it should be regularly tested and updated to ensure that it is operationally sound.

We agree with this comment and we now propose a new § 652.35(e) imposing CFP requirements. We view these proposed CFP requirements as prudent and integral to an organized and systematic approach to managing liquidity risk and ensuring ongoing compliance with board policy pertaining to liquidity risk -- as well as generally consistent with the spirit of the guidance issued in the Interagency Policy Statement and by the Basel Committee and, thus, with emerging industry best practices.[38]

In § 652.35(e)(1) we propose to require Farmer Mac to have a CFP to ensure sources of liquidity are sufficient to fund normal operating requirements under a variety of stress events, which we specify in paragraph (3)(v) and discuss below.[39]

Section 652.35(e)(2) would require Farmer Mac's board of directors to review and approve the CFP at least once each year and to make adjustments to reflect changes in the results of stress tests, the Corporation's risk profile, and market conditions. Under the CFP, Farmer Mac would have to maintain unencumbered and highly marketable assets as described in paragraphs (b) and (c) of § 652.40 in its liquidity reserve sufficient to meet its liquidity needs based on estimated cash inflows and outflows for a 30-day time horizon under a stress scenario that is sufficiently acute as to be consistent with the level of the board's risk tolerance.

This effectively creates an additional liquidity metric to the traditional days-of-liquidity metric in the existing rule -- which is retained, though revised, in this proposed rule.[40] The difference between the two metrics lies in the stress scenario considered in each. The existing days-of-liquidity metric compares highly marketable assets (appropriately discounted) to actual maturing debt over a given time interval at the date of calculation. In essence the stress applied is a lack of access of debt markets. The requirement proposed in § 652.35(e)(2) is based on an appropriately estimated, more comprehensive, stress scenario specifically calibrated to the board's established risk tolerance level. We propose this additional regulatory standard to achieve better consistency with the objectives and recommendations envisioned under Basel III .[41]

Under § 652.35(e)(3), the CFP would have to:

- Be customized to the financial condition and liquidity risk profile of Farmer Mac, the board's liquidity risk tolerance, and the Corporation's business model;
- Identify funding alternatives that can be implemented as access to funding is reduced. For example, it would have to include, at a minimum, collateral pledging arrangements to secure funding and possible capital-raising initiatives;
- Establish a process for managing events that imperil the Corporation's liquidity. The process must assign appropriate personnel and executable action plans to implement the CFP; and
- Require periodic stress testing that analyzes the possible impacts on Farmer Mac's cash flows, liquidity position, profitability, and solvency for a wide variety of stress scenarios. Stress scenarios would have to be established and defined by the board and should be consistent with those applied in other areas of the Corporation's risk analysis, i.e., those proposed in § 652.10 (Investment Management) and § 652.30 (Interest Rate Risk Management). The basis for assumptions must be documented and well-reasoned. The stress

scenarios would have to be at a level of severity consistent with the board's risk tolerance and include scenarios such as market disruptions; rapid increase in contractually required loan purchases; unexpected requirements to fund commitments or revolving lines of credit or to fulfill guarantee obligations; difficulties in renewing or replacing funding with desired terms and structures; requirements to pledge collateral with counterparties; or reduced access to debt markets as a result of asset quality deterioration (including both program assets and non-program assets). FCA would also retain the discretion to require certain specific stress scenarios in response to changes in market and economic outlooks.

To satisfy these requirements, the CFP would have to set forth specific policies, procedures, and action steps (including which asset classes will be sold under specific scenarios) with designated responsibilities, to address a range of contingent scenarios that are internal to Farmer Mac or external, such as sector-wide or market-wide disruptions. For example, the CFP should include an external communications plan for how the Corporation will manage press inquiries during a liquidity event. Poor external communications during a liquidity event could directly, if inadvertently, increase the severity of the event. FCA could use its reservation of authority to require specific stress scenarios to be used, for example, in response to developments in the Agency's outlook for Farmer Mac's business environment.

J. Section 652.40--Liquidity Reserve Requirement and Supplemental Liquidity

Existing § 652.20(a) requires Farmer Mac to hold cash, eligible non-program investments, and/or Farmer Mac II assets (all subject to specified discounts) to maintain sufficient liquidity to fund a minimum of 60 days of maturing obligations, interest expense, and operating expenses. The purpose of this minimum liquidity requirement is to enable Farmer Mac to continue its operations if its access to the capital markets were impeded or otherwise disrupted.

As discussed in the ANPRM, we recognize that a drawback of the "days-of-liquidity" metric is that it provides no projected information; a large days-of-liquidity today provides little or no information about what the measurement might be even the following day. For example, a bank with 150 days-of-liquidity today might issue a very large volume of discount notes the following day that mature in 100 days. This issuance could significantly reduce the days-of-liquidity calculated only the day before. A well-managed financing operation will evaluate the days-of-liquidity metric against its short-term anticipated funding needs, i.e., how that measurement might change in the very near future. A funding strategy that combines short-term debt with long-term swaps could make the days-of-liquidity measurement highly volatile under plausible scenarios.

Both the Council and AgFirst commented that that the days-of-liquidity approach to liquidity management is appropriate and widely used. We received no comments suggesting alternative metrics, and we do not propose any such alternative. We note, however, that the proposed LMMP discussed above would contribute to management of the shortcomings in the days-of-liquidity metric.

1. Section 652.40(a)--General

In contrast to current regulation, proposed § 652.40(a) (which would replace existing § 652.20(a) in the existing regulations) would require Farmer Mac to maintain a liquidity reserve equal to at least 90 days of maturing obligations and other borrowings. In its comment letter, AgFirst suggested that a 90-day liquidity reserve would lead to improved liquidity risk management as well as to consistency with System bank practices.

We established the current 60-day minimum in 2005 as part of our first rulemaking governing Farmer Mac's liquidity risk management. We set the minimum lower than minimums discussed in the regulatory literature at the time, e.g., regulations governing other Farm Credit System institutions, to avoid unintended consequences on Farmer Mac's operations as we introduced this regulation for the first time. Farmer Mac has since increased its liquidity position substantially and in our view a higher minimum would advance the Corporation's safety and soundness.

In addition to the proposed increase in the minimum requirement, we propose to simplify the components of the calculation of days-of-liquidity in proposed § 652.40(a) by including only obligations and other borrowings[42] and to no longer include interest obligations or operational expenses. While those obligations are deemed no less relevant, the increased minimum will, we believe, more than compensate for the exclusion of these obligations from the calculation while gaining the benefit of reduced complexity in the regulatory structure. Thus, while we do not suggest that the effects of the increased requirement and the simplified calculation are perfectly offsetting, we note that there is such an overall offsetting effect and that a net increase in the standard is intended.

The liquidity reserve could be comprised only of cash and of specified, highly marketable investments that are discussed below. Also as discussed below, the investments would have to be discounted as specified.

We also propose in § 652.40(a) to require Farmer Mac to maintain supplemental liquidity as required by the table in paragraph (d) of this section. As discussed below, the supplemental liquidity requirement in the table at paragraph (d) would require Farmer Mac to maintain assets to fund obligations maturing after 90 calendar days in an amount necessary to meet its board liquidity policy. As discussed below, supplemental liquidity could be comprised of cash, eligible investments, and qualifying securities backed by Farmer Mac program assets (loans); the investments and qualifying securities would have to be discounted as specified.

2. Section 652.40(b)--Unencumbered

In proposed § 652.40(b), we would require that all investments and qualifying securities used to meet the liquidity reserve and supplemental liquidity requirements must be unencumbered, and we propose a description of the term "unencumbered." This requirement would replace the requirement in existing § 652.20(b) that investments held to meeting the liquidity reserve requirement must be free of liens or other encumbrances.

We propose this new terminology to bring greater clarity and precision to this requirement. We propose the term unencumbered to mean free of lien and not pledged either explicitly or implicitly in any way to secure, collateralize, or enhance the credit of any transaction. Investments held as a hedge against any other exposure would also not be unencumbered.

As noted throughout this preamble, FCA considers the guidance of other regulators in developing its policy proposals and evaluates their benefits and appropriateness for Farmer Mac. We note that the Liquidity Coverage Ratio standard recommended by Basel includes various forms of funding commitments and contingency funding commitments of the regulated entity.[43] We request comment on whether such commitments should be incorporated into the minimum liquidity reserve requirements in this rule. Specifically with regard to Farmer Mac, should Long-term Standby Purchase Commitments (LTSPC) be considered contingent obligations and some portion of the outstanding LTSPC volume be included in the days-of-liquidity calculation? Should its revolving lines of credit be included among these and, if so, what proportion? Should an estimated draw on its commitments on processing facilities, if any, be included in obligations?

3. Section 652.40(c)--Highly Marketable

In proposed § 652.40(c) we relocate and replace the requirement currently found at § 652.35(c) that non-program investments be readily marketable with the requirement that investments held for the purpose of meeting the liquidity reserve minimum must be highly marketable. An investment is considered to be highly marketable if it possesses the following characteristics:

- It is easily and immediately convertible to cash with little or no loss in value;
- It has low credit and market risk;
- It has ease and certainty of valuation; and
- Except for money market instruments, it is listed on a developed and recognized exchange market and is able to be sold or converted to cash through repurchase agreements in active and sizable markets.

The first three characteristics are consistent with the expectations of the other regulators concerning highly liquid investments.[44] The final characteristic is unchanged from the existing rule.

The newly proposed language clarifies that the requirement applies only to investments included in the liquidity reserve and not to all eligible investments generally. The relocation of this requirement to a regulation dealing with liquidity from one governing eligible investments generally further emphasizes the scope of the requirement. In addition, investments held to provide supplemental liquidity would not have to meet the "highly marketable" test. We note that our interpretation of the term "immediate" in the description of "highly marketable" will consider the overall quality of the investment. For example, if an investment is both backed by the full faith and credit of the United States Government but also thinly traded, its conversion at little or no loss in value may be uncertain within a single trading day, yet very certain within a very small number of days. Such very high credit-quality investments would qualify for Level 1 or Level 2 depending on a conservative estimate of the number of days required –- and not be relegated to supplemental liquidity simply on the basis that liquidation could take a very small number of days.

4. Section 652.40(d)-–Composition of Liquidity Reserve and Supplemental Liquidity

The existing liquidity requirement, at § 652.20(a), requires Farmer Mac to hold sufficient cash, eligible non-program investments, and/or Farmer Mac II assets sufficient to fund at least 60 days of maturing obligations, interest expense, and operating expenses. The requirement does not currently differentiate among the relatively different liquidity characteristics of different types of investments.

We asked in the ANPRM whether it would be appropriate to establish a subcategory of the minimum days-of-liquidity requirement that would include assets that would not lose liquidity value in a market downturn, such as cash and Treasury securities, that would be sufficient to meet maturing obligations for a lesser number of days. In its comment letter, the Council stated that augmentation of liquidity through a short-term liquidity calculation contemplating cash and highly liquid investment securities is part of a prudent liquidity strategy. AgFirst commented that the days-of-liquidity approach to liquidity management can be enhanced by including subcategories of minimum days provided by different types of assets, and it noted that it and the other System banks have adopted a tiered liquidity system such as this.

We agree with these comments and propose to strengthen the existing days-of-liquidity requirement by adopting a tiered approach to the liquidity requirement.

Proposed § 652.65(d) would require Farmer Mac to continuously maintain Level 1 and Level 2 investments sufficient to meet the 90-day minimum liquidity requirement. It would also require Farmer Mac to maintain supplemental liquidity in an amount necessary to meet its board's liquidity policy.

Level 1 investments would be the most liquid investments. Investments that would qualify as Level 1 investment are cash, Treasury securities, other Government agency obligations, Government-sponsored agency securities (except mortgage securities) that mature within 60 days, and diversified investment funds comprised exclusively of Level 1 instruments.

Under the proposal, only Level 1 instruments could be used to fund obligations maturing in calendar days 1 through 30. In addition, at least 15 days must be comprised only of cash or instruments with remaining maturities of less than 3 years.

Level 2 investments, while still highly marketable, are deemed to be generally less liquid than Level 1 instruments. Investments that qualify as Level 2 instruments include Level 1 instruments to the extent Level 1 qualifying volume exceeds 30 days of maturing obligations, Government-sponsored agency securities (excluding mortgage securities) with maturities exceeding 60 days, Government-sponsored agency mortgage securities (excluding Farmer Mac's own securities), money market instruments maturing within 90 days, and diversified investments funds with holdings comprised entirely of Level 1 or Level 2 instruments.

Under the proposal, the third tier of liquidity investments are those that can be held for supplemental liquidity. Supplemental liquidity investments are used to fund obligations maturing after 90 calendar days, as necessary to meet the Farmer Mac board's liquidity policy.

Investments that can be held for supplemental liquidity include all eligible investments, as well as qualifying securities backed by Farmer Mac program assets (loans) guaranteed by the USDA, excluding the portion that would be necessary to satisfy obligations to creditors and equity holders in Farmer Mac II LLC. We consider this portion to be encumbered and therefore not appropriate for inclusion in supplemental liquidity under § 652.65(b). These are generally the investments that are counted toward the liquidity reserve requirement under existing § 652.20(a).

5. <u>Section 652.40(e)—Discounts</u>

Existing § 65.20(c) specifies discounts for various classes of investments in the liquidity reserve, including money market instruments, floating and fixed rate debt and preferred stock securities, diversified investment funds, and Farmer Mac II assets. In the ANPRM, we asked whether, in the wake of recent disruptions in financial markets, it would be appropriate to re-evaluate these discounts to reflect better the risk of diminished marketability of liquid investments under adverse conditions. We asked commenters to identify any changes they believed we should make. In addition, we specifically asked whether the discount currently applied to Farmer Mac II securities is appropriate. We also asked whether we should consider basing discounts on credit ratings.

We received no comments on our general question about discounts or on our question about Farmer Mac securities. The Council did comment that discounts should not be based on credit ratings, because the market value of a security (discounts applied to market values) is a timelier and more accurate reflection of liquidity and risk than credit ratings are. For this reason, and also because of section 939A of the DFA, we agree that discounts should not be based on credit ratings.

In proposed § 652.40(e), we propose discounts that better fit the proposed tiered structure of the minimum liquidity reserve requirement. We believe the proposed discounting structure results in reduced complexity in the regulation.

The proposed discounts are as follows:

- Multiply cash and overnight investments by 100 percent.
- Multiply Treasury securities by 97 percent of their market value. This would be a lessening of the current discount for Treasury securities which, along with all other fixed rate debt securities, are currently multiplied by 90 percent.[45] This level is reasonably consistent with discounts applied by the Federal Reserve;[46] and
- Multiply all other Level 1 qualifying investments by 95 percent of their market value (even if some of these instruments are counted toward the Level 2 liquidity reserve requirements due to a surplus of Level 1 qualifying instruments over the Level 1 liquidity reserve requirements). We believe this discount level is likely to be lower than the average discount applied to this portion of Farmer Mac's portfolio historically, but we believe it is warranted by the relative liquidity of these instruments;[47]
- Multiply all Level 2 investments by 93 percent of their market value, except the volume of Level 1 qualifying investments that exceed the Level 1 liquidity reserve requirement and is therefore applied to the Level 2 liquidity reserve requirement. This level is similar to the existing rule's treatment of such investments with similar cash flows; and
- Multiply all other investments held for supplemental liquidity by 85 percent of market value, except:
    - Multiply the volume of Level 1-qualifying investments that exceed the Level 1 or Level 2 liquidity reserve requirement by 95 percent;
    - Multiply the volume of Level 2 qualifying investments that exceed the Level 2 liquidity reserve requirements by 93 percent; and
    - Multiply securities backed by Farmer Mac program assets (loans) guaranteed by the United States Department of Agriculture as described in section 8.0(9)(B) of the Act by 75 percent, the same as the existing discount.

We believe the 15-percent supplemental liquidity discount is warranted in light of our proposal not to require these investments to be "highly marketable." Moreover, this requirement is also based on guidance in Basel III.[48]

The proposed 25-percent discount for Farmer Mac II assets is unchanged from the existing rule.

6. <u>Section 652.40(f)—Reservation of Authority</u>

In § 652.40(f), we propose to reserve the right, on a case-by-case basis, to require Farmer Mac to adjust its treatment of instruments (assets) in its liquidity reserve and supplemental liquidity so that it has liquidity that is sufficient and commensurate for the risks its faces. This reservation of authority enables FCA to respond to adverse financial, economic, or market conditions by requiring Farmer Mac, on a case-by-case basis, to:

- Increase the specified discounts that are applied to any individual security or any class of securities due to changes in market conditions or marketability of such securities;
- Shift individual or multiple securities from one level of the liquidity reserve to another, or between one of the levels of the liquidity reserve and supplemental liquidity, based on the

performance of such asset(s), or based on financial, economic, or market conditions affecting the liquidity and solvency of Farmer Mac;
- Change portfolio concentration limits in § 652.20(a); or
- Take any other action that we deem necessary to ensure that Farmer Mac has sufficient liquidity to meet its financial obligations as they come due.

This reservation of authority would enable FCA to respond to adverse financial, economic, or market conditions by giving us the authority to require Farmer Mac to maintain liquidity that is sufficient and commensurate for the risks its faces.

K. Section 652.45-–Temporary Regulatory Waivers or Modifications for Extraordinary Situations

We propose to relocate existing § 652.30, which authorizes FCA to modify or waive regulatory investment management and liquidity management requirements in extraordinary situations, to new § 652.45. We believe this location is more appropriate for this provision.

In addition to the existing specific modifications and waivers the provision authorizes, we propose to authorize FCA to take other actions as deemed appropriate. This added authority would give FCA additional flexibility to address extraordinary situations.

VI. Regulatory Flexibility Act

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

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[1] Section 652.5 defines "non-program investments" as investments other than those in (1) "qualified loans" as defined in section 8.0(9) of the Farm Credit Act of 1971, as amended (Act), or (2) securities collateralized by "qualified loans." Section 8.0(9) is codified at 12 U.S.C. 2279aa.

[2] 75 FR 27951.

[3] Under certain specific adverse circumstances, Farmer Mac is authorized to issue debt to the Department of the Treasury to meet obligations on guarantees. See section 8.13 of the Act (12 U.S.C. 2279aa-13).

[4] 12 CFR 652.25.

[5] We view the management of non-program investment earnings performance as including both the avoidance of underperforming appropriate benchmarks for this portfolio as well as avoiding performance that is excessive relative to appropriate benchmarks -- as excessive returns can reasonably be viewed as indications of excessive liquidity risk. We discuss this concept at length in our ANPRM, at 75 FR 27952-53. We continue to study this concept but do not propose regulatory guidance regarding the establishment of such benchmarks at this time.

[6] See 75 FR 13656, Mar. 22, 2010. These agencies are the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUS).

[7] "Principles for Sound Liquidity Risk Management and Supervision," Basel Committee on Banking Supervision, September 2008, and "International framework for liquidity risk management, standards and monitoring," Consultative Document, Basel Committee on Banking Supervision, December 2009. These documents can be found on the Basel Committee's Web site at www.bis.org/bcbs.

[8] Section 8.33 of the Act (12 U.S.C. 2279bb-2).

[9] 75 FR 27952-53, May 19, 2010.

[10] A similar requirement is currently contained in § 652.15(d)(5), and we therefore propose to delete that provision.

[11] In the proposal, the quarterly stress testing requirement would be located at § 652.10(f)(3). We would delete § 652.40 as a stand-alone stress testing regulation. In addition, the proposed regulation would impose stress testing in § 652.30(c)(3), as part of interest rate risk management, and in § 652.35(e)(3)(v), as part of the contingency funding plan (CFP). We expect that Farmer Mac will integrate these stress testing requirements to the extent appropriate.

[12] Paragraph (b) permits Farmer Mac to hold eligible non-program investments, for specified purposes, up to 35 percent of program volume.

[13] Under existing § 652.20(b), all investments held for the purpose of meeting the liquidity reserve requirement must be free of liens or other encumbrances. As discussed below, we propose a more detailed version of this requirement at § 652.40(b).

[14] In this context, "purchase" would include an acquisition such as a swap of one security in exchange for another. This interpretation is consistent with our interpretation of the existing rule.

[15] The proposed rule would make a minor, non-substantive change to the language in this provision to reflect the slightly revised definition of "Government agency" we propose in § 652.5. We intend no change in meaning with this proposed revision.

[16] Section 652.5 defines Government-sponsored agency as an agency, instrumentality, or corporation chartered or establish to serve public purposes specified by the United States Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the United States, including but not limited to any Government-sponsored enterprise. We propose a minor, technical change in this definition.

[17] In light of the proposed changes to this provision, we propose to delete the § 652.35(d)(1) limitation. We discuss that proposal below.

[18] Generally, the WAL is the average amount of time required for each dollar of invested principal to be repaid, based on the cashflow structure of an ABS and an assumed level of prepayments. Nearly all ABS

are priced and traded on the basis of their WAL, not their final maturity dates.

[19]See § 615.5140(a)(6).

[20]These limits are consistent with those recently proposed for the other System institutions. See 76 FR 51289, Aug. 18, 2011.

[21]See § 615.5140(a)(7).

[22]GICS was developed by Morgan Stanley Capital International and Standards and Poor's. The GICS is an industry analysis framework for investment research portfolio management and asset allocation. The GICS structure consists of 10 sectors, 24 industry groups, 68 industries, and 154 sub-industries. More information can be found at www.mscibarra.com/products/indices/gics.

[23]76 FR 51289, Aug. 18, 2011.

[24]76 FR 35138, June 16, 2011.

[25]76 FR 51289, Aug. 18, 2011.

[26]For example, the OCC, the Federal Reserve, the FDIC, and the OTS issued an ANPRM at 75 FR 52283, Aug. 25, 2010. The Federal Housing Finance Agency issued an ANPRM at 76 FR 5292, Jan. 31, 2011.

[27]In addition, existing § 652.35(b), which we propose to renumber as § 652.20(c), provides that whenever the obligor or issuer of an eligible investment is located outside the United States, the host country must maintain the highest sovereign rating for political and economic stability by an NRSRO. The DFA requires us to replace that NRSRO standard with an appropriate substitute. The following discussion also applies to that provision.

[28]76 FR 35138, June 16, 2011.

[29]76 FR 51289, Aug. 18, 2011.

[30]We note that the other FCS institutions do not have an obligor limit for Government-sponsored agencies, and no such limit is proposed in the recent NPRM. See § 615.5140(d)(1) of our regulations and 76 FR 51289, Aug. 18, 2011.

[31]Existing § 652.45(a)(1) pertains to the divestiture requirements of investments that became ineligible when the divestiture regulation initially became effective in 2005. Because there is no longer a need for these initial divestiture requirements, we propose to delete them.

[32]These investments would no longer be considered "ineligible."

[33]In this context, "purchase" would include an acquisition such as a swap of one ineligible security for another.

[34]We discussed this concept in our ANPRM at 75 FR 27953-27954.

[35]As discussed above, proposed § 652.35(b)(10) would require that the LMMP be contained in Farmer Mac's liquidity policy.

[36]Although not specified in the rule, guidance must be focused on the avoidance of maturity concentrations that would cause the Corporation to exceed the board's risk tolerance.

[37]"Principles for Sound Liquidity Risk Management and Supervision," Basel Committee on Banking Supervision, September 2008 (or successor document, in the future). This document can be found at http://www.bis.org/publ/bcbs144.htm.

[38]75 FR 13656, Mar. 22, 2010, and "Principles for Sound Liquidity Risk Management and Supervision," Basel Committee on Banking Supervision, www.bis.org/bcbs, respectively.

[39]As discussed above, proposed § 652.35(b)(1) would require that the CFP be contained in Farmer Mac's liquidity policy.

[40]Days-of-liquidity is discussed below.

[41]Page 3 of "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring" Basel Committee on Banking Supervision, December 2010, www.bis.org/bcbs.

[42]The term "other borrowings" is used to make clear that all forms borrowing should be included even if some do not technically take the form of debt, such as obligations under repurchase agreements.

[43]Page 12 of "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring," www.bis.org/bcbs.

[44]See Interagency Policy Statement, 75 FR 13658, 13664, Mar. 22, 2010.

[45]Section 652.20(c)(5).

[46]Information on Federal Reserve collateral margins can be found at www.frbdiscountwindow.org. Click on the link to Collateral Margins Table.

[47]The reason we use the term "Level 1 qualifying instruments" is to make clear that if Farmer Mac holds cash, Treasuries, and other Level 1 investments such that a portion of that Level 1 qualifying investment volume exceeds the 30 calendar days required of Level-1 investment volume and therefore is available to cover a portion of the 60-day Level 2 requirement, those Level 1 qualifying investments will not be discounted at seven percent as all other Level 2 investments but rather at the applicable Level 1 discount. This ensures equal discounting treatment regardless of whether Level 1 investments are applied to the Level 1 or Level 2 requirement. It also removes the potential incentive for Farmer Mac to reduce the proportion of higher liquidity assets that qualify as Level 1 instruments in excess of the Level 1 minimum requirement that it might prefer to hold absent this regulatory structure.

[48]Page 9 of "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring," December 2010, www.bis.org/bcbs.

List of Subjects in 12 CFR Part 652

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

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

PART 652--FEDERAL AGRICULTURAL MORTGAGE CORPORATION FUNDING AND FISCAL AFFAIRS

1. Subpart A, consisting of §§ 652.1 through 652.45, is revised to read as follows:

Subpart A--Investment Management

Sec.

Authority: Secs. 4.12, 5.9, 5.17, 8.11, 8.31, 8.32, 8.33, 8.34, 8.35, 8.36, 8.37, 8.41 of the Farm Credit Act (12 U.S.C. 2183, 2243, 2252, 2279aa-11, 2279bb, 2279bb-1, 2279bb-2, 2279bb-3, 2279bb-4, 2279bb-5, 2279bb-6, 2279cc); sec. 514 of Pub. L. 102-552, 106 Stat. 4102; sec. 118 of Pub. L. 104-105, 110 Stat. 168; sec. 939A of Pub. L. 11-203, 124 Stat. 1326, 1887.

Subpart A--Investment Management

§ 652.1 Purpose.

The purpose of this subpart is to ensure safety and soundness, continuity of funding, and appropriate use of non-program investments considering the Federal Agricultural Mortgage Corporation's (Farmer Mac or Corporation) special status as a Government-sponsored enterprise (GSE). The subpart contains requirements for Farmer Mac's board of directors to adopt policies covering the management of non-program investments, funding and liquidity risk, and interest rate risk. The subpart also requires Farmer Mac to comply with various reporting requirements.

§ 652.5 Definitions.

For purposes of this subpart, the following definitions will apply:

Affiliate means any entity established under authority granted to the Corporation under section 8.3(c)(14) of the Farm Credit Act of 1971, as amended.

Asset-backed securities (ABS) mean investment securities that provide for ownership of a fractional undivided interest or collateral interests in specific assets of a trust that are sold and traded in the capital markets. For the purposes of this subpart, ABS exclude mortgage securities that are defined below.

Cash means cash balances held at Federal Reserve Banks, proceeds from traded-but-not-yet-settled debt, and the insured amount of balances held in deposit accounts at Federal Deposit Insurance Corporation-insured banks.

Contingency Funding Plan (CFP) is described in § 652.35(e).

Eurodollar time deposit means a non-negotiable deposit denominated in United States dollars and issued by an overseas branch of a United States bank or by a foreign bank outside the United States.

Farmer Mac, Corporation, you, or your means the Federal Agricultural Mortgage Corporation and its affiliates.

FCA, our, us, or we means the Farm Credit Administration.

Final maturity means the last date on which the remaining principal amount of a security is due and payable (matures) to the registered owner. It does not mean the call date, the expected average life, the duration, or the weighted average maturity.

General obligations of a state or political subdivision mean:

(1) The full faith and credit obligations of a state, the District of Columbia, the Commonwealth of Puerto Rico, a territory or possession of the United States, or a political subdivision thereof that possesses general powers of taxation, including property taxation; or

(2) An obligation that is unconditionally guaranteed by an obligor possessing general powers of taxation, including property taxation.

Government agency means the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations *are* fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States Government.

Government-sponsored agency means an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the United States Congress but whose obligations *are not* explicitly insured or guaranteed by the full faith and credit of the United States Government, including but not limited to any Government-sponsored enterprise.

Liability Maturity Management Plan (LMMP) is described in § 652.35(d).

Liquidity reserve is described in § 652.40.

Long-Term Standby Purchase Commitment (LTSPC) is a commitment by Farmer Mac to purchase specified eligible loans on one or more undetermined future dates. In consideration for Farmer Mac's assumption of the credit risk on the specified loans underlying an LTSPC, Farmer Mac receives an annual commitment fee on the outstanding balance of those loans in monthly installments based on the outstanding balance of those loans.

Market risk means the risk to your financial condition because the value of your holdings may decline if interest rates or market prices change. Exposure to market risk is measured by assessing the effect of changing rates and prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire Corporation.

Maturing obligations mean maturing debt and other obligations that may be expected, such as buyouts of LTSPCs or repurchases of agricultural mortgage securities.

Mortgage securities mean securities that are either:

(1) Pass-through securities or participation certificates that represent ownership of a fractional undivided interest in a specified pool of residential (excluding home equity loans), multifamily or commercial mortgages, or

(2) A multiclass security (including collateralized mortgage obligations and real estate mortgage investment conduits) that is backed by a pool of residential, multifamily or commercial real estate mortgages, pass-through mortgage securities, or other multiclass mortgage securities.

(3) This definition does not include agricultural mortgage-backed securities guaranteed by Farmer Mac itself.

Nationally recognized statistical rating organization (NRSRO) means a rating organization that the Securities and Exchange Commission recognizes as an NRSRO.

Non-program investments mean investments other than those in:

(1) "Qualified loans" as defined in section 8.0(9) of the Farm Credit Act of 1971, as amended; or

(2) Securities collateralized by "qualified loans."

OSMO means FCA's Office of Secondary Market Oversight.

Program assets mean on-balance sheet "qualified loans" as defined in section 8.0(9) of the Farm Credit Act of 1971, as amended.

Program obligations mean off-balance sheet "qualified loans" as defined in section 8.0(9) of the Farm Credit Act of 1971, as amended.

Regulatory capital means your core capital plus an allowance for losses and guarantee claims, as determined in accordance with generally accepted accounting principles.

Revenue bond means an obligation of a municipal government that finances a specific project or enterprise, but it is not a full faith and credit obligation. The obligor pays a portion of the revenue generated by the project or enterprise to the bondholders.

Weighted average life (WAL) means the average time until the investor receives the principal on a security, weighted by the size of each principal payment and calculated under specified prepayment assumptions.

§ 652.10 Investment management.

(a) *Responsibilities of the board of directors*. Your board of directors must adopt written policies for managing your non-program investment activities. Your board must also ensure that management complies with these policies and that appropriate internal controls are in place to prevent loss. At least annually, your board, or a designated committee of the board, must review and affirmatively validate the sufficiency of these investment policies. Any changes to the policies must be adopted by the board. You must report any changes to these policies to the OSMO within 10 business days of adoption.

(b) *Investment policies--general requirements.* Your investment policies must address the purposes and objectives of investments, risk tolerance, delegations of authority, internal controls, due diligence, and reporting requirements. Furthermore, the policies must include reporting requirements and approvals needed for exceptions to the board's policies. Investment policies must be sufficiently detailed, consistent with, and appropriate for the amounts, types, and risk characteristics of your investments. You must document in the Corporation's records or minutes any analyses used in formulating your policies or amendments to the policies.

(c) *Investment policies--risk tolerance*. Your investment policies must establish risk limits for the various types, classes, and sectors of eligible investments. These policies must ensure that you maintain prudent diversification of your investment portfolio and that your asset allocations and investment portfolio strategies do not expose the Corporation's capital or earnings to excessive risk of loss. Risk limits must be based on the Corporation's objectives, capital position, and risk tolerance. Your policies must identify the types and quantity of investments that you will hold to achieve your objectives and control credit, market, liquidity, and operational risks. Your policies must establish risk limits for the following four types of risk:

(1) *Credit risk.* Your investment policies must establish:

(i) Credit quality standards, limits on counterparty risk, and risk diversification standards that limit concentrations as follows: Concentration limits must be based on a single or related counterparty(ies). Concentration limits must also be based on geographical area, industry sectors, or asset classes or obligations with similar characteristics.

(ii) Criteria for selecting brokers, dealers, and investment bankers (collectively, securities firms). You must buy and sell eligible investments with more than one securities firm. As part of your review of your investment policies required under paragraph (a) of this section, your board of directors, or a designated committee of the board, must review the criteria for selecting securities firms. Any changes to the criteria must be approved by the board. Also, as part of your review required under paragraph (a) of this section, the board, or a designated committee of the board, must review existing relationships with securities firms and determine whether to continue your relationships with them. Any changes to the existing relationships with securities firms must be approved by the board.

(iii) Collateral margin requirements on repurchase agreements. You must regularly mark the collateral to market and ensure appropriate controls are maintained over collateral held.

(2) *Market risk*. Your investment policies must set market risk limits for specific types of investments and for the investment portfolio.

(3) *Liquidity risk*. Your investment policies must describe the liquidity characteristics of eligible investments that you will hold to meet your liquidity needs and the Corporation's objectives.

(4) *Operational risk*. Investment policies must address operational risks, including delegations of authority and internal controls in accordance with paragraphs (d) and (e) of this section.

(d) *Delegation of authority*. All delegations of authority to specified personnel or committees must state the extent of management's authority and responsibilities for investments.

(e) *Internal controls*. You must:

(1) Establish appropriate internal controls to detect and prevent loss, fraud, embezzlement, conflicts of interest, and unauthorized investments.

(2) Establish and maintain a separation of duties and supervision between personnel who execute investment transactions and personnel who post accounting entries, reconcile trade confirmations, report compliance with investment policy, and approve, revalue, and oversee investments.

(3) Maintain records and management information systems that are appropriate for the level and complexity of your investment activities.

(4) Implement an effective internal audit program to review, at least annually, your investment controls, processes, and compliance with FCA regulations and other regulatory guidance. Your internal audit program must specifically include a review of your process for ensuring all investments are eligible and suitable for purchase under your board's investment policies.

(f) *Due diligence*.

(1) *Pre-purchase analysis*.

(i) *Objective, eligibility, and suitability*. Before you purchase an investment, you must document your investment objective. In addition, you must conduct sufficient due diligence to determine whether the investment is eligible under § 652.20 and suitable under your board-approved investment policies, and you must document the investment's eligibility and suitability. Your investment policies must fully address the extent of pre-purchase analysis that management must perform for various types, classes, and structure of investments.

(ii) *Valuation*. Prior to purchase, you must verify the value of the investment (unless it is a new issue) with a source that is independent of the broker, dealer, counterparty or other intermediary to the transaction.

(iii) *Risk assessment*. You must document your risk assessment of each investment. Your risk assessment must at a minimum include an evaluation of:

(A) *Credit risk*. As applicable, you must consider the nature and type of underlying collateral, credit enhancements, complexity of the structure, and any other available indicators of the risk of default.

(B) *Market risk*. You must consider how various market stress scenarios including, at a minimum, potential changes in interest rates and market conditions (such as changes in market perceptions of creditworthiness), are likely to affect the cash flow and price of the instrument, using reasonable and appropriate methodologies for stress testing for the type or class of instrument to ensure the investment complies with risk limits established in your investment and interest rate risk policies.

(C) *Liquidity risk*. Your evaluation of liquidity risk must consider the investment structure, depth of the market, and ability to liquidate the position under a variety of economic scenarios and market conditions.

(2) *Monthly fair value determination*. At least monthly, you must determine the fair market value of each investment in your portfolio and the fair market value of your whole investment portfolio.

(3) *Quarterly stress testing.*

(i) You must stress test your entire investment portfolio on a quarterly basis. If your portfolio risk exceeds your investment policy limits, you must develop a plan to reduce risk and comply with your investment policy limits.

(ii) Your stress tests must be comprehensive and appropriate for the risk profile of your investment portfolio and the Corporation. At a minimum, the stress tests must consider how potential changes in interest rates and market conditions (including market perceptions of creditworthiness) are likely to affect the cash flow and price of the instrument. The methodology that you use to analyze investment securities must be appropriate for the complexity, structure, and cash flows of the investments in your portfolio. The stress tests must enable you to determine that your investment securities, either individually or on a portfolio-wide basis, do not expose your capital, earnings, or liquidity to excessive risks. You must rely to the maximum extent practicable on verifiable information to support all your assumptions, including prepayment and interest rate volatility assumptions, when you apply your stress tests. Your assumptions must be conservative and you must document the basis for all assumptions that you use to evaluate the security and its underlying collateral. You must also document all subsequent changes in your assumptions.

(4) *Presale value verification.* Before you sell an investment, you must verify its value with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction.

(g) *Reports to the board of directors*. At least quarterly, executive management must report on the following to the board of directors or a designated committee of the board:

(1) Plans and strategies for achieving the board's objectives for the investment portfolio;

(2) Whether the investment portfolio effectively achieves the board's objectives;

(3) The current composition, quality, and liquidity profile of the investment portfolio;

(4) The performance of each class of investments and the entire investment portfolio, including all gains and losses that you incurred during the quarter on individual securities that you sold before maturity and why they were liquidated;

(5) Potential risk exposure to changes in market interest rates as identified through quarterly stress testing and any other factors that may affect the value of your investment holdings;

(6) How investments affect your capital, earnings, and overall financial condition;

(7) Any deviations from the board's policies. These deviations must be formally approved by the board of directors.

§ 652.15 Non-program investment purposes and limitation.

(a) Farmer Mac is authorized to hold eligible non-program investments listed under § 652.20 for the purposes of enterprise risk management, including complying with the interest rate risk requirements in § 652.30 and the liquidity requirements in § 652.40; managing surplus short-term funds; and complementing program business activities.

(b) Non-program investments cannot exceed 35 percent of program assets and program obligations, excluding qualifying securities that are both guaranteed by the United States Department of Agriculture and included as a potential source of supplemental liquidity in § 652.40(d). When calculating the total amount of non-program investments under this section, exclude investments pledged to meet margin requirements on derivative transactions.

§ 652.20 Eligible non-program investments.

(a) You may purchase only the investments that satisfy the eligibility criteria in this section. An investment that does not satisfy the eligibility criteria at the time of purchase is not eligible for purchase and is subject to the requirements of § 652.20(a) if purchased. An investment that satisfies the eligibility criteria at the time of purchase but subsequently fails to satisfy the eligibility criteria is subject to the requirements of § 652.25(b).

ASSET CLASS	FINAL MATURITY LIMIT	NRSRO ISSUE OR ISSUER CREDIT RATING REQUIREMENT	OTHER REQUIREMENTS	MAXIMUM PERCENTAGE OF TOTAL NON-PROGRAM INVESTMENT PORTFOLIO
(1) Obligations of the United States Obligations (except mortgage securities) fully insured or guaranteed by a Government agency.	None	NA	None	None
(2) Obligations of Government-sponsored agencies · Government-sponsored agency securities (except mortgage securities). · Other obligations (except mortgage securities) fully insured or guaranteed by Government-sponsored agencies.	None	NA	Senior debt securities only	None
(3) Municipal Securities				
· General obligations	10 years	One of the two highest.	None	15%
· Revenue bonds	10 years	Highest	None	15%
(4) International and Multilateral Development Bank Obligations	10 years	None	The United States must be a voting shareholder.	15%
(5) Money Market Instruments				
· Federal funds	1 day or continuously callable up to 100 days	One of the two highest short-term.	None	None
· Negotiable certificates of deposit	1 year	One of the two highest short-term.	None	None

· Bankers acceptances	None	One of the two highest short-term.	Issued by a depository institution.	None
· Prime commercial paper	270 days	Highest short-term.	None	None
· Non-callable term Federal funds and Eurodollar time deposits.	100 days	Highest short-term.	None	20%
· Master notes	270 days	Highest short-term.	None	20%
· Repurchase agreements collateralized by eligible investments or marketable securities rated in the highest credit rating category by an NRSRO.	100 days	NA		None

Note: You must also comply with requirements of paragraphs (b), (c), and (d) of this section. "NA" means not applicable.

ASSET CLASS	**FINAL MATURITY LIMIT**	**NRSRO ISSUE OR ISSUER CREDIT RATING REQUIREMENT**	**OTHER REQUIREMENTS**	**MAXIMUM PERCENTAGE OF TOTAL NON-PROGRAM INVESTMENT PORTFOLIO**
(6) Mortgage Securities				
· Fully insured or guaranteed by a Government agency.	None	NA		None
· Government-sponsored agency mortgage securities.	None	One of the two highest.		50%
· Securities that are not fully insured or fully guaranteed by a Government agency or Government- sponsored agency and that comply with 15 U.S.C. 77d(5) or 15 U.S.C. 78c(a)(41).	None	Highest	Senior-most position only	10%
(7) Asset-Backed Securities secured by: Credit card receivables Automobile loans	None	Highest	Maximum of 5-year WAL for fixed rate or floating rate ABS at their contractual interest rate	15% in total, and no more than 5% of any single collateral type.

Home equity loans Wholesale automobile dealer loans Student loans Equipment loans Manufactured housing loans			caps. Maximum of 7-year WAL for floating rate ABS that remain below their contractual interest rate caps.	
(8) Corporate Debt Securities	5 years	One of the highest two for maturities greater than 3 years, and one of the highest three for maturities of three years or less.	Senior debt securities only. Cannot be convertible to equity securities.	20% in total, and no more than 10% in any one of the 10 industry sectors as defined by the Global Industry Classification Standard (GICS)
(9) Diversified Investment Funds Shares of an investment company registered under section 8 of the Investment Company Act of 1940.	NA	NA	Open-end funds only The portfolio of the investment company must consist solely of eligible investments authorized by this section. The investment company's risk and return objectives and use of derivatives must be consistent with FCA guidance and your investment policies.	50% in total. No more than 10% in any single fund;

Note: You must also comply with requirements of paragraphs (b), (c), and (d) of this section. "NA" means not applicable.

(b) *Denomination*. All investments must be denominated in United States dollars.

(c) *Rating of foreign countries*. Whenever the obligor or issuer of an eligible investment is located outside the United States, the host country must maintain the highest sovereign rating for political and economic stability by an NRSRO.

(d) *Obligor limits*.

(1) You may not invest more than 15 percent of your regulatory capital in eligible investments issued by any single entity, issuer or obligor, except that there are no obligor limits on obligations (including mortgage securities) that are issued or guaranteed as to principal and interest by Government agencies or Government-sponsored agencies.

(2) *Obligor limits for your holdings in an investment company*. You must count securities that you hold through an investment company toward the obligor limits of this section unless the investment company's holdings of the security of any one issuer do not exceed 5 percent of the investment company's total portfolio.

(e) *Other investments approved by the FCA*.

(1) You may purchase and hold other non-program investments only with our prior written approval. Your request for our approval must explain the risk characteristics of the investment and your purpose and objectives for making the investment.

§ 652.25 Management of ineligible and unsuitable investments.

(a) *Investments ineligible when purchased*. Investments that do not satisfy the eligibility criteria set forth in § 652.20 at the time of purchase are ineligible. You may not purchase ineligible investments. If you determine that you have purchased an ineligible investment, you must notify the OSMO promptly after such determination and must divest of the investment no later than 60 calendar days after the determination unless we approve, in writing, a plan that authorizes you to divest of the investment over a longer period of time.

(b) *Investments that no longer satisfy eligibility criteria or are unsuitable*. If an investment (that satisfied the eligibility criteria set forth in § 652.20 when purchased) no longer satisfies the eligibility criteria, or if an investment is unsuitable under your board's policy, you must notify the OSMO promptly.

(c) *Requirements for investments that are ineligible, no longer satisfy eligibility criteria, or are unsuitable*.

(1) *Reporting requirements*. Each quarter, you must report to the OSMO and your board on the status of investments identified in paragraph (a) or (b). Your report must demonstrate the impact that these investments may have on the Corporation's capital, earnings, and liquidity position. Additionally, the report must address how the Corporation plans to reduce its risk exposure from these investments or exit the position(s).

(2) *Other requirements*. Investments identified in paragraph (a) or (b) may not be used to fund your liquidity reserve or supplemental liquidity required under § 652.40. These investments must continue to be included the investment portfolio limit established in § 652.15(b).

(d) *Reservation of authority*. FCA retains the authority to require you to divest of any investment at any time for safety and soundness reasons. The timeframe set by FCA for such required divestiture will consider the expected loss on the transaction (or transactions) and the impact on the Corporation's financial condition and performance.

§ 652.30 Interest rate risk management.

(a) The board of directors of Farmer Mac must provide effective oversight (direction, controls, and supervision) of interest rate risk management and must be knowledgeable of the nature and level of interest rate risk taken by Farmer Mac.

(b) The board of directors of Farmer Mac must adopt an interest rate risk management policy that establishes appropriate interest rate risk exposure limits based on the Corporation's risk-bearing capacity and reporting requirements in accordance with paragraphs (c) and (d) of this section. At least annually, the board of directors, or a designated committee of the board, must review the policy. Any changes to the policy must be approved by the board of directors. You must report any changes to the policy to the OSMO within 10 business days of adoption.

(c) The interest rate risk management policy must, at a minimum:

(1) Address the purpose and objectives of interest rate risk management;

(2) Identify the causes of interest rate risk and set appropriate quantitative limits consistent with a clearly articulated board risk tolerance;

(3) Require management to establish and implement comprehensive procedures to measure the potential impact of these risks on the Corporation's projected earnings and market values by conducting interest rate stress tests and simulations of multiple economic scenarios at least quarterly. Your stress tests must gauge how interest rate fluctuations affect the Corporation's capital, earnings, and liquidity position. The methodology that you use must be appropriate for the complexity of the structure and cash flows of your on- and off-balance sheet positions, including the nature and purpose of derivative contracts, and establish counterparty risk thresholds and limits for derivatives. It must also ensure an appropriate level of consistency with the stress-test scenarios considered under § 652.10(f)(3). Assumptions applied in stress tests must be conservative and, to the maximum extent practicable, must rely on verifiable information. You must document the basis for all assumptions that you use.

(4) Describe and authorize management to implement actions needed to achieve Farmer Mac's desired risk management objectives;

(5) Ensure procedures are established to evaluate and document, at least quarterly, whether actions taken have actually met the Corporation's desired risk management objectives;

(6) Identify exception parameters and approvals needed for any exceptions to the policy's requirements;

(7) Describe delegations of authority; and,

(8) Describe reporting requirements, including exceptions to policy limits.

(d) At least quarterly, management must report to the Corporation's board of directors, or a designated committee of the board, describing the nature and level of interest rate risk exposure. Any deviations from the board's policy on interest rate risk must be specifically identified in the report and approved by the board, or a designated committee of the board.

§ 652.35 Liquidity management.

(a) *Liquidity policy--board responsibilities*. Farmer Mac's board of directors must adopt a liquidity policy, which may be integrated into a comprehensive asset-liability management or enterprise-wide risk management policy. The risk tolerance embodied in the liquidity policy must be consistent with the investment management policies required by § 652.10 of this part. The board must ensure that management uses adequate internal controls to ensure compliance with its liquidity policy. At least annually, the board of directors or a designated committee of the board must review and affirmatively validate the sufficiency of the liquidity policy. The board of directors must approve any changes to the policy. You must provide a copy of the revised liquidity policy to the OSMO within 10 business days of adoption.

(b) *Policy content*. Your liquidity policy must contain at a minimum the following:

(1) The purpose and objectives of liquidity reserves;

(2) A listing of specific asset classes and characteristics that can be used to meet liquidity objectives;

(3) Diversification requirements for your liquidity reserve portfolio;

(4) Maturity limits and credit quality standards for non-program investments used to meet the minimum liquidity requirements of § 652.40 (d);

(5) The minimum and target (or optimum) amounts of liquidity that the board has established for

Farmer Mac, expressed in days of maturing obligations;

(6) The maximum amount of non-program investments that can be held for meeting Farmer Mac's liquidity needs, expressed as a percentage of program assets and program obligations;

(7) Exception parameters and post approvals needed with respect to the liquidity reserve;

(8) Delegations of authority pertaining to the liquidity reserve;

(9) Reporting requirements which must comply with the requirements under paragraph (c) of this section;

(10) A liability maturity management plan (LMMP), as described in § 652.35(d); and,

(11) A contingency funding plan (CFP), as described in § 652.35(e).

(c) *Reporting requirements*.

(1) *Board reporting*.

(i) *Periodic*. At least quarterly, Farmer Mac's management must report to the Corporation's board of directors or a designated committee of the board describing, at a minimum, the status of the Corporation's compliance with board policy and the performance of the liquidity reserve portfolio.

(ii) *Special*. Management must report any deviation from the bank's liquidity policy, or failure to meet the board's liquidity targets immediately to the board.

(2) *OSMO reporting*. Farmer Mac must report, in writing, to the OSMO no later than the next business day following the discovery of any breach of the minimum liquidity reserve requirement at § 652.40.

(d) *Liability maturity management plan*. Your board must adopt a LMMP that establishes a funding strategy that provides for effective diversification of the sources and tenors of funding. The LMMP must:

(1) Include targets of acceptable ranges of the proportion of debt issuances maturing within specific time periods;

(2) Reflect the board's liquidity risk tolerance; and

(3) Consider components of the Corporation's funding strategy that offset, or contribute to, liquidity risk.

(e) *Contingency funding plan*.

(1) *General*. Farmer Mac must have a CFP to ensure sources of liquidity are sufficient to fund normal operating requirements under a variety of stress events described in paragraph (e)(3)(iv) of this section.

(2) *CFP requirements*. The board of directors must review and approve the CFP at least once each year and must make adjustments to reflect changes in the results of stress tests, the Corporation's risk profile, and market conditions. Under the CFP, Farmer Mac must maintain unencumbered and highly marketable assets as described in paragraphs (b) and (c) of § 652.40 in its liquidity reserve sufficient to meet its liquidity needs based on estimated cash inflows and outflows for a 30-day time horizon under a stress scenario that is sufficiently acute as to be consistent with the level of the board's risk tolerance.

(3) The CFP must:

(i) Be customized to the financial condition and liquidity risk profile of Farmer Mac, the board's liquidity risk tolerance, and the Corporation's business model;

(ii) Identify funding alternatives that can be implemented as access to funding is reduced;

(iii) Establish a process for managing events that imperil Farmer Mac's liquidity. The process must assign appropriate personnel and executable action plans to implement the CFP; and,

(iv) Require periodic stress testing that analyzes the possible impacts on Farmer Mac's cash flows, liquidity position, profitability, and solvency for a wide variety of stress scenarios. Stress scenarios must be established and defined by the board and consistent with those applied in other areas of the Corporation's risk analysis. Assumptions applied must be conservative and their basis documented. The stress scenarios must be at a level of severity consistent with the board's risk tolerance and include scenarios such as market disruptions; rapid increase in contractually required loan purchases; unexpected requirements to fund commitments or revolving lines of credit or to fulfill guarantee obligations; difficulties in renewing or replacing funding with desired terms and structures; requirements to pledge collateral with counterparties; or reduced access to debt markets as a result of asset quality deterioration (including both program assets and non-program assets). FCA may, at its discretion, require certain specific stress scenarios in response to changes in market and economic outlooks.

§ 652.40 Liquidity reserve requirement and supplemental liquidity.

(a) *General*. Farmer Mac must maintain a liquidity reserve in accordance with paragraph (d) of this section sufficient to fund 90 days of the principal portion of maturing obligations and other borrowings at all times. The liquidity reserve must be comprised only of cash and investments, eligible under § 652.20, that are specified under paragraph (d) of this section. Farmer Mac must also maintain supplemental liquidity as required by paragraph (d) of this section. Supplemental liquidity must be comprised of cash, investments that are eligible under § 652.20, and qualifying securities backed by Farmer Mac program assets (loans) as specified in paragraph (d) of this section. Investments and qualifying securities comprising the liquidity reserve and supplemental liquidity must be discounted in accordance with paragraph (e) of this section.

(b) *Unencumbered*. All investments and qualifying securities held for the purpose of meeting the liquidity reserve and supplemental liquidity requirements of this section must be unencumbered, meaning free of lien, not pledged either explicitly or implicitly in any way to secure, collateralize, or enhance the credit of any transaction, and not held as a hedge against any other exposure.

(c) *Highly marketable*. All investments that Farmer Mac holds for the purpose of meeting the liquidity reserve minimum requirements of this section must be highly marketable. For purposes of this section, an investment is highly marketable if it possesses the following characteristics:

(1) It is easily and immediately convertible to cash with little or no loss in value;

(2) It has low credit and market risk;

(3) It has ease and certainty of valuation; and

(4) Except for money market instruments, it is listed on a developed and recognized exchange market and is able to be sold or converted to cash through repurchase agreements in active and sizable markets.

(e) *Composition of liquidity reserve and supplemental liquidity*. Farmer Mac must continuously maintain Level 1 and Level 2 investments described in the table below sufficient to meet the 90-day minimum liquidity requirement in paragraph (a) of this section. Farmer Mac must also maintain supplemental liquidity as required by the table below.

Level 1 Investments: Instruments used to fund obligations maturing in calendar days 1 through 30. At least 15 days of the Level 1 requirement must be comprised of cash or instruments with remaining maturities of less than 3 years.	· Cash. · Treasury securities. · Other Government agency obligations. · Government-sponsored agency securities (excluding mortgage securities) that mature within 60 days. · Diversified Investment Funds comprised exclusively of Level 1 instruments.
Level 2 Investments: Instruments used to fund obligations maturing in calendar days 31 through 90.	· Additional amounts of Level 1 Instruments, · Government-sponsored agency securities (excluding mortgage securities) with maturities

	exceeding 60 days · Government-sponsored agency mortgage securities (excluding Farmer Mac securities). · Money Market instruments maturing within 90 days. · Diversified Investment Funds comprised of Level 1 or 2 instruments.
<u>Supplemental Liquidity</u>: Assets to fund obligations maturing after 90 calendar days in an amount necessary to meet board liquidity policy in accordance with § 652.35.	· Eligible investments under § 652.20. · Qualifying securities backed by Farmer Mac program assets (loans) guaranteed by the United States Department of Agriculture (excluding the portion that would be necessary to satisfy obligations to creditors and equity holders in Farmer Mac II LLC).

(e) *<u>Discounts</u>*. The liquid assets of the liquidity reserve and supplemental liquidity are discounted as follows:

(1) Multiply cash and overnight investments by 100 percent;

(2) Multiply Treasury securities by 97 percent of the market value;

(3) Multiply all other Level 1 qualifying instruments by 95 percent of their market value, even if some of these instruments are counted toward the Level 2 liquidity reserve requirements due to a surplus of Level 1 qualifying instruments over the Level 1 liquidity reserve requirements.

(4) Multiply all Level 2 Instruments by 93 percent of the market value, except the volume of Level 1 qualifying instruments that exceeds the Level 1 liquidity reserve requirement and is therefore applied to the Level 2 liquidity reserve requirement, as described in paragraph (e)(3) of this section; and

(5) Multiply all other investments held for supplemental liquidity by 85 percent of market value, except:

(i) The volume of Level 1 qualifying instruments that exceeds the Level 1 or Level 2 liquidity reserve requirements, as described in paragraph (e)(3) of this section; and

(ii) The volume of Level 2 qualifying instruments that exceeds the Level 2 liquidity reserve requirements, as described in paragraph (e)(4) of this section; and,

(iii) Multiply securities backed by Farmer Mac program assets (loans) guaranteed by the United States Department of Agriculture as described in section 8.0(9)(B) of the Act by 75 percent.

(f) *<u>Reservation of authority</u>*. FCA reserves the right, on a case-by-case basis, to require Farmer Mac to adjust its treatment of instruments (assets) in its liquidity reserve and supplemental liquidity so that it has liquidity that is sufficient and commensurate for the risks its faces. This reservation of authority enables FCA to respond to adverse financial, economic, or market conditions by requiring Farmer Mac, on a case-by-case basis, to:

(1) Increase the discounts specified in paragraph (e) of this section that are applied to any individual security or any class of securities due to changes in market conditions or marketability of such securities;

(2) Shift individual or multiple securities from one level of the liquidity reserve to another, or between one of the levels of the liquidity reserve and supplemental liquidity based on the performance of such asset(s), or based on financial, economic, or market conditions affecting the liquidity and solvency of Farmer Mac;

(3) Change portfolio concentration limits in § 652.20(a); or

(4) Take any other action that the Farm Credit Administration deems necessary to ensure that

Farmer Mac has sufficient liquidity to meet its financial obligations as they come due.

§ 652.45 Temporary regulatory waivers or modifications for extraordinary situations.

Whenever the FCA determines that an extraordinary situation exists that necessitates a temporary regulatory waiver or modification, the FCA may, in its sole discretion:

(a) Modify or waive the minimum liquidity reserve requirement in § 652.40 of this subpart;

(b) Modify the amount, qualities, and types of eligible investments that you are authorized to hold pursuant to § 652.20 of this subpart; and/or

(c) Take other actions as deemed appropriate.

Dated: November 10, 2011

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.

76 FR 35138, 06/16/2011

Handbook Mailing HM-11-7

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 652

RIN 3052-AC70

Federal Agricultural Mortgage Corporation Funding and Fiscal Affairs; Farmer Mac Risk-Based Capital Stress Test, Version 5.0

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: In this advance notice of proposed rulemaking (ANPRM), the Farm Credit Administration (FCA, we, us, our) is requesting comments on alternatives to using credit ratings issued by nationally recognized statistical ratings organizations (NRSRO or credit rating agency) in regulations addressing the Risk-Based Capital Stress Test (RBCST or stress test) for the Federal Agricultural Mortgage Corporation (Farmer Mac or FAMC). Recent legislation requires every Federal agency to remove any references to credit ratings from its regulations and to substitute them with other standards of creditworthiness considered appropriate. Additionally, in response to this same legislative emphasis on ensuring appropriate prudential oversight of derivatives transactions, we are considering whether the RBCST should include a more explicit and comprehensive capital charge for counterparty risk stemming from derivative transactions. Lastly, through the ANPRM we are seeking public input on how we might revise the operational and strategic business planning requirements for FAMC to place greater emphasis on diversity and inclusion.

DATES: You may send comments on or before August 15, 2011.

ADDRESSES: We offer a variety of methods for you to submit comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we no longer accept comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters", then "Public Comments", and follow the directions for "Submitting a Comment".
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Laurie A. Rea, Director, Office of Secondary Market Oversight, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters", then "Public Comments", and follow the directions for "Reading Submitted Public Comments". We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4434,

Or

Laura McFarland, Senior Counsel, Office of the General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objective

The purpose of this ANPRM is to gather public input on how FCA might:

- Revise existing Farmer Mac RBCST regulations to replace data from credit rating agencies.
- Comprehensively address derivative counterparty exposure in the RBCST; and
- Revise operational and strategic business planning requirements to place greater emphasis on diversity and inclusion.

II. Background

Farmer Mac is an institution of the Farm Credit System, regulated by FCA through the FCA Office of Secondary Market Oversight (OSMO). Farmer Mac was established and chartered by Congress to create a secondary market for agricultural real estate mortgage loans, rural housing mortgage loans, and rural utilities loans, and it is a stockholder-owned instrumentality of the United States. Title VIII of the Farm Credit Act of 1971, as amended, (Act) governs Farmer Mac.[1]

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) was enacted.[2] Section 939A of the Dodd-Frank Act requires Federal agencies to review all regulatory references to NRSRO credit ratings and replace those references with other appropriate standards for determining creditworthiness. The Dodd-Frank Act further provides that, to the extent feasible, agencies should adopt a uniform standard of creditworthiness for use in regulations, taking into account the entities regulated and the purposes for which such regulated entities would rely on the creditworthiness standard.

The FCA uses credit rating agency data in its RBCST regulations for Farmer Mac. Section 8.32 of the Act required FCA to establish a risk-based capital stress test for Farmer Mac's portfolio.[3] This stress test determines the level of regulatory capital necessary for Farmer Mac to maintain positive capital during a 10-year period where stressful credit and interest rate conditions occur. We first published regulations on the stress test, and other requirements related to section 8.32 of the Act, in the Federal Register at 66 FR 19048 (April 12, 2001). Since then, we revised the stress test several times, most recently to capture capital requirements for Farmer Mac's rural utilities authorities. The existing RBCST for Farmer Mac is contained in 12 CFR part 652, subpart B, and it currently relies, in part, on NRSRO credit ratings when calculating regulatory minimum capital requirements.

We have comprehensively reviewed our regulations that use or rely on credit ratings, including other sections in part 652 which govern Farmer Mac's non-program investments and liquidity reserve requirements. This ANPRM is one of several notices and proposed rules on which we will be seeking public input relating to use of credit ratings in our rules.

A. Farmer Mac Programs

Under the Farmer Mac I program, FAMC guarantees prompt payment of principal and interest on securities representing interests in, or obligations backed by, mortgage loans secured by first liens on agricultural real estate or rural housing. It also purchases, or commits to purchase, qualified loans or securities backed by qualified loans directly from lenders. Under the Farmer Mac II program, FAMC purchases and securitizes portions of certain loans guaranteed by the U.S. Department of Agriculture, including farm ownership and operating loans and rural business and community development loans. Farmer Mac also guarantees the timely payment of principal and interest on the securities created from these loans. In 2008, Congress granted Farmer Mac the authority to purchase and guarantee securities backed by loans to rural electric and telephone utility cooperatives as program business.[4] Farmer Mac also provides a secondary market for USDA-guaranteed farm program and rural development loans.

B. Risk-based Capital and Credit Ratings

Under our rules, Farmer Mac's regulatory capital must be sufficient so that it would remain positive during the 10-year time horizon of the stress test. One component of the RBCST accounts for the risk of loss on specific types of program investments (i.e., investments backed by agricultural real estate mortgage loans, rural housing loans, or rural utility cooperative loans) that include credit enhancement features. In this context, credit risk is adjusted downward based on the whole-letter credit rating of the counterparty on AgVantage and similarly structured assets. The adjustment is made to recognize the risk-reducing strength of the counterparty's general obligation backing of these securities. These securities are further backed by eligible loan collateral.

Another component of the RBCST estimates counterparty risk associated with non-program investments, e.g., corporate debt, asset-backed securities and mortgage- related securities. In this context, the RBCST reduces earnings at rates related to the cumulative historical default and recovery rates of corporate debt by whole-letter credit rating category as published by Moody's Investor Services.[5] The RBCST's calculations in each of these two components use five whole-letter rating categories. It then assigns counterparties into these categories by referencing ratings issued by an NRSRO for the counterparty. The regulations, in turn, specify the change in expected cash flows during the stress period to reflect the risk of default by a counterparty based in part on the assigned ratings category. The changes in cash flows decrease projected losses on program assets and decrease earnings on non-program investments, which then translate to changes in equity over the modeling horizon and affect the required minimum regulatory capital calculated by the stress test.

FCA initially chose to use NRSRO ratings in the RBCST as a source of objective and neutral third-party assessments of the credit risk for particular instruments and counterparties. We used ratings because they were readily and publicly available. The use of NRSRO ratings was also, at the time, believed to offer enhanced consistency in credit evaluation across different components of the RBCST. In 2010, the Dodd-Frank Act addressed, in part, the structure of credit rating agencies, requiring revisions and imposing other requirements in an effort to resolve the conflicts of interest and other difficulties believed to be at the center of the 2008-2009 financial market crisis. The Dodd-Frank Act also questioned the value of these ratings when used as the primary data source in the assessment of the creditworthiness of a security or money market instrument. In connection with that, the Dodd-Frank Act requires every Federal agency to remove any reference to, or reliance on, credit rating agencies in its regulations and replace any such reference with an alternative standard of credit worthiness considered appropriate for the regulatory purpose. As a result, we are seeking suggestions on what alternative data sources would be most appropriate for the RBCST.

C. Considerations and Objectives for a New Approach to Quantifying Relative Creditworthiness

FCA believes that any new standard of creditworthiness should distinguish between different levels of credit risk, in an accurate and timely manner, and be transparent in its approach. We believe it should also be applied consistently across the multiple components of the RBCST and be reasonably simple, while not unduly burdensome to apply and not be easily subject to manipulation. FCA recognizes that any resulting system will likely involve trade-offs among these objectives, e.g., simple versus accurate and timely, accurate and timely versus not burdensome to apply.

To eliminate the use of NRSRO ratings in calculating risk-based capital requirements for Farmer Mac, we need to develop an alternative basis to assess counterparty risk. One approach may be to identify objective criteria that Farmer Mac could apply to categorize credit exposures into different risk classes and assess counterparty risk accordingly. The criteria may be broadly designated. For example, credit exposures could be divided into government and non-government, secured and unsecured, or other categories, such as maturity. Such a broad approach, however, may not be able to sufficiently and consistently account for difference in relative risk among exposures that fall into the same category. FCA may also consider adopting criteria that reference certain financial or other metrics related to the obligor or counterparty. To be meaningful, the criteria would need to account for or bear a reasonable correlation to the potential riskiness of default among different obligors or counterparties. Any criteria would also need to be readily obtainable for all relevant counterparties by FCA, Farmer Mac and the public or it might not be sufficiently transparent and objective. The standards would need to ensure that the investment or position is not speculative, and carries credit risk appropriate for Farmer Mac's risk profile and the authorized purposes for non-program investments. As any new counterparty risk evaluation approach is initiated, there is the potential for increased risk as the new system is implemented.

FCA might also consider an approach that builds on Farmer Mac's internal credit review process and allows it to assign risk ratings to various categories and assess risk based on qualitative and quantitative standards set by FCA regulations. For example, FCA could assign loss rate estimates based on Farmer Mac's internal ratings or some modification of such, as reviewed or approved by FCA – or simply review or approve Farmer Mac's mapping of its assigned risk ratings to estimated loss rates. This approach would be more subjective than the alternative discussed above but could allow FCA to leverage the data collection and analysis already performed by Farmer Mac. Under this approach, FCA would likely rely heavily on the supervisory process to make sure that Farmer Mac is strictly following its internal guidelines and not assuming high levels of credit risk.

Questions (1) through (11) of Section III of this ANPRM address this topic.

D. Counterparty Risk on Derivatives

As part of our Dodd-Frank Act review and the increasing emphasis by the financial industry on ensuring appropriate prudential oversight of derivatives transactions, we are also considering whether the RBCST should include a more explicit and comprehensive capital charge for counterparty risk stemming from derivative transactions.

The RBCST produces a single comprehensive capital requirement for Farmer Mac by modeling changes in cash flows under a specific statutory stress scenario. We believe there may be opportunities to revise the RBCST to add a representation of counterparty default exposure on derivatives transactions by considering both net replacement cost as well as current exposure to individual cash flows based on an assessment of the counterparty's creditworthiness.

Questions (12) and (13) of Section III. of this ANPRM address this topic.

E. Capital and Business Planning

As part of this ANPRM, we are seeking input on how we might revise § 652.60(b) on operational and strategic business planning requirements to place greater emphasis on diversity and inclusion in both Farmer Mac's personnel as well as the borrowers and lenders who benefit from its secondary market activities.

We believe an integral part of promoting and achieving inclusion and diversity can be accomplished through an effective operational plan that includes strategies to seek out qualified loans from a diverse group of sources and provides rural lenders with financing products that serve a diverse array of borrowers, such as small, beginning, new, disabled, female, and minority farmers, ranchers, and rural homeowners, as well as cooperatives with diversity of ownership. We believe promotion of inclusion and diversity should also extend to non-traditional agricultural producers, such as local food systems, organic or specialty crop farmers, and community-supported agriculture.

Additionally, we are considering whether Farmer Mac's operational and strategic plans should include strategies and actions to achieve diversity and inclusion within FAMC's workforce, management, and governance structure, as well as an assessment of the progress FAMC has made in this area. We are also contemplating whether the plans should describe FAMC's succession programs.

Questions (14) and (15) of Section III. of this ANPRM address this topic.

III. Request for Comments

FCA regulations governing the Farmer Mac RBCST contain specific references to credit ratings issued by NRSROs for purposes of calculating regulatory minimum capital requirements. FCA is issuing this ANPRM to identify standards that may be appropriate replacements for credit ratings issued by NRSROs, which maintain compliance with statutory design requirements for the RBCST. Other regulatory agencies have also issued ANPRMs as part of their process to address references to credit ratings in their capital regulations and prudential standards.[6] We encourage any interested person(s) to submit comments on the following questions and ask that you support your comments with relevant data or examples. We remind commenters that comments and data submitted in support of a comment are available to the public through our rulemaking files.

1. What core principles would be most important in FCA's development of new standards of creditworthiness?

2. What qualitative and quantitative standards would FCA need to set to implement an approach that relied on the Farmer Mac to generate internal estimates of counterparty risk exposures? What are the strengths and weaknesses of such an approach?

3. Is it important that FCA's approach to replacing its reliance on credit rating agency data be consistent with that of other financial regulators or with those of other Farm Credit System institutions? If so, how important and why?

4. What specific creditworthiness or investment criteria should FCA use in its RBCST regulation?

5. What types of objective criteria should be used to differentiate credit exposures and apply meaningful counterparty risk estimates in the RBCST?

6. Should different criteria be used for different broad classes of investments or exposures? If so, what perverse incentives or other unintended consequences could that lead to? For example, could criteria that are perceived to be more flexible or subjective for a given asset class incent the regulated entity to accept a proportion of exposure to that asset class relative to its entire program (or non-program) portfolio that it might deem excessive without that incentive?

7. What approach would estimate a meaningful and consistent level of counterparty risk for a variety of exposures by employing publicly available qualitative and quantitative metrics, such as individual obligor credit spreads and/or financial ratio analysis to estimate probability of default and recovery rates?

8. Alternatively, could such estimates be reasonably made at the level of the market (e.g., identifying an index of industry sector spreads and stratifying spreads into certain ranges) and mapped to loss rates set by FCA?

9. How might a set of loss rates be developed for each spread stratum?

10. Are there any existing objective tools or approaches that could readily replace references to ratings issued by NRSROs in the RBCST?

11. What other approaches or methodologies not discussed above should FCA consider?

12. What methodologies or approaches should FCA consider to more explicitly incorporate a derivatives counterparty exposure charge into the RBCST?

13. What is the best manner of evaluating minimum capital requirements on derivative counterparty exposures in the RBCST and should a pre-processing model be constructed (i.e., a sub-model used to derive inputs into the RBCST) to represent this risk--both in terms of missed individual contractual cash flows as well the replacement cost on defaulted derivatives? If so, how should replacement costs be estimated?

14. Should Farmer Mac be required to include strategies in its marketing plans that address how its secondary market programs and products will be offered to all qualified borrowers, including:

(a) Minorities, the disabled, and women;

(b) Young, beginning, small, and family farms and cooperatives; or

(c) Non-traditional agricultural producers, such as local food systems, organic or specialty crop farmers and the lenders who serve them? Why or why not?

15. Should Farmer Mac's marketing plans set quantitative goals to increase purchases of, or commitments to purchase, loans to young, beginning, small, and family farms, and those owned or operated by minorities, the disabled, and women? If so, what would be the best method to apply such goals to rural utility cooperatives (e.g., minority-managed cooperatives or cooperatives that serve predominantly minority residential customers or minority-owned commercial customers)?

16. To what extent should FCA regulations require Farmer Mac to develop a human capital plan as part of its strategic and operational business plan to foster diversity in its workforce and succession planning?

Dated: June 10, 2011

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

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[1] Pub. L. 92-181, 85 Stat. 583, 12 U.S.C. 2001 et seq. (December 10, 1971).

[2] Pub. L. 111-203, 124 Stat. 1376, (H.R. 4173), July 21, 2010.

[3] 12 U.S.C. 2279bb-1.

[4] Section 5406 of Pub. L. 110-246, 122 Stat. 1651 (June 18, 2008)(repealing and replacing Pub. L. 110-234).

[5] Emery K., Ou S., Tennant, J., Kim F., Cantor R., “Corporate Default and Recovery Rates, 1920 – 2009,” published by Moody’s Investors Service, February 2010.

[6] See 75 FR 49423 (Aug. 13, 2010), 75 FR 52283 (Aug. 25, 2010), and 76 FR 5292 (Jan. 31, 2011).

77 FR 3172, 01/23/2012

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[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Parts 611, 612, 619, 620 and 630

RIN 3052-AC41

Compensation, Retirement Programs, and Related Benefits

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, us, we, or our) proposes to amend our regulations related to Farm Credit System (System) bank and association disclosures to shareholders and investors. The proposed rule would require reporting of supplemental retirement plans, a discussion of the link between senior officer compensation and performance, and timely and transparent reporting to shareholders of significant events that occur between annual reporting periods. We believe the proposed changes will provide full, transparent and consistent disclosures to shareholders. The proposed rule would identify the minimum responsibilities a compensation committee must perform to ensure it continues to exercise good stewardship, and require that System banks and associations provide for a nonbinding, advisory vote on senior officer compensation in order to engage shareholders in the management and control of their institution. Also, the proposed rule would bifurcate existing annual reporting requirements at § 620.5 and make other conforming technical changes.

DATES: Submit comments on or before March 23, 2012.

ADDRESSES: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we no longer accept comments submitted by fax. Regardless of the method you use, please do not submit your comments multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send an e-mail to reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration,

1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Deborah Wilson, Senior Accountant, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434,

or

Laura McFarland, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objective

The objectives of this proposed rule are to:

- Improve the transparency and completeness of disclosures in System institution annual reports or annual meeting information statements (collectively, Report) by requiring disclosure of all components of senior officer[1] compensation and retirement benefits;

- Promote the continued safety and soundness of System institutions by requiring certain oversight responsibilities of compensation committees;

- Strengthen timely communication with System shareholders on significant events that occur between annual reporting periods;

- Provide shareholders with a clear and complete understanding of their institution's obligations and commitments related to supplemental retirement benefit plans (SRP) for employees other than the senior officer group; and

- Encourage member participation in the control and management of their institution by providing voting shareholders an opportunity to cast a nonbinding, advisory vote on senior officer compensation.

II. Background

The Farm Credit Act of 1971, as amended (Act),[2] authorizes the FCA to issue regulations implementing the Act's provisions.[3] Our regulations are intended to ensure the safe and sound operations of System institutions and to govern the disclosure of financial information to shareholders of, and investors in, the System. Congress explained in section 514 of the Farm Credit Banks and Associations

Safety and Soundness Act of 1992 (1992 Act)[4] that disclosures of financial information and compensation paid to senior officers, among other disclosures, provide System shareholders with information necessary to better manage their institution and make informed decisions regarding the operation of their institution.

Section 1.1(b) of the Act sets forth the objective to continue to encourage owners-borrowers to participate in the management, control, and ownership of their cooperative. In an October 14, 2010, Resolution of the Farm Credit Administration Board, we declared our commitment to support the cooperative business model and structure of System banks and associations.[5] The FCA emphasizes the cooperative structure and principles by advancing regulatory proposals that encourage borrowers to participate in the management, control and ownership of their institution.

A. Comments Received

On November 18, 2010, we issued an advance notice of proposed rulemaking (ANPRM) on disclosure of senior officer compensation and related topics in order to gather information for the development of a proposed rulemaking.[6] We received 99 comment letters in response to the ANPRM from individuals and entities associated with the System, including the Farm Credit Council (FCC), acting for its membership, and the Federal Farm Credit Banks Funding Corporation (Funding Corporation). We reviewed all comment letters and evaluated their recommendations in recognition of existing law and policy considerations and the cooperative nature of the System. We are proposing rules and amendments related to senior officer compensation disclosures and related topics that were discussed in the ANPRM. Other topics in the ANPRM not included in this rulemaking may be considered in future rulemakings.[7]

We are actively reviewing the authority of the Funding Corporation's System Audit Committee (SAC) to have "unfettered ability to engage outside advisors." Section 630.6 authorizes the Funding Corporation board to deny, by a two-thirds majority vote of the full board, any SAC request for resources. The SAC requested we consider amending our regulations to remove this authority. We addressed this issue in the ANPRM and most commenters responded that it would be imprudent to provide absolute discretion on the use of resources to any bank or association board committee. The FCC expressed the view of its membership that existing FCA regulations appropriately balance audit committee need with the board's ultimate responsibility to the customer-shareholder for the safety and financial stability of the institution. However, the FCC also noted that its membership supported the Funding Corporation's request. The SAC's response to the ANPRM was that the SAC believed it must have every resource it requires at its disposal to effectively perform its function. We are not proposing changes to this authority in this rulemaking, but may revisit the matter in future rulemakings.

B. Proposed Rule

We periodically review and update our disclosure regulations to ensure they are appropriate for current business practices, provide shareholders with necessary information, and provide investors with information necessary to assist them in making investment decisions. In keeping with today's changing economic and business environments, and in accordance with the findings of Congress under the 1992 Act and the FCA Board Resolution of October 14, 2010, we believe it is appropriate to review and update our rules on senior officer compensation disclosures and other related topics. We believe that banks and associations can continue to support the cooperative business model, fulfill the System's public policy mission in a safe and sound manner, and best serve their members by providing shareholders:

- Complete disclosure that allows them to understand senior officer compensation and retirement policies and practices and all compensation and retirement benefit obligations;

- Timely and transparent communication on significant or material events affecting their institution; and

- A nonbinding, advisory vote on senior officer compensation.

We believe the proposed rule continues to balance meaningful disclosures, committee oversight, and shareholder rights with institution safety and soundness.

III. Section-by-Section Analysis

A. Bifurcation of Annual Reporting Requirements Sections [existing § 620.5(h) through (k); new § 620.6]

To enhance the clarity and organization of our rules, we propose moving the disclosure requirements for directors and senior officers in § 620.5(h) through (k) to new § 620.6. Also, we propose that § 620.5(h) contain a reference to § 620.6, stating that the presentation of the § 620.6 disclosures would continue to be required in the annual report. We propose no changes to the current requirements of existing § 620.5(h), (j), and (k), except for minor rewording of the language and cross citations to recognize the proposed new locations at § 620.6(a), (b), (d), (e), and (f). However, in the process of moving § 620.5(h) through (k) to new § 620.6, some regulatory language is proposed to be changed in existing § 620.5(i) to remove redundancy and enhance clarity. Specifically, we propose clarifying how highly compensated employees, who are not senior officers, are treated in the Summary Compensation Table (Compensation Table) at new § 620.6(c)(2)(i).

Also, we propose clarifying where to disclose the required statement that the information on compensation for any individual senior officer, as disclosed in the Compensation Table, is available to shareholders upon request. In new § 620.6(c)(2)(ii), we propose that the statement must be presented directly beneath the Compensation Table because we believe the notice of this right should be in close proximity to the related disclosure. We propose new disclosure requirements that would be contained in new § 620.6(c) and are discussed in Part III.B. of the preamble to this proposed rule.

As conforming technical changes, we propose changing references to the annual report's director and senior officer compensation and conflicts of interest disclosures, made in other areas of our rules, to their location in new § 620.6. Specifically changing references contained in § 611.330(b) of our rules from § 620.5(j) and (k) to § 620.6(e) and (f); changing references contained in § 612.2145(a)(2) of our rules from § 620.5(k) to § 620.6(f); changing references contained in § 612.2155(a)(2) of our rules from § 620.5(k) to § 620.6(f); adding § 620.6 to the references contained in §§ 612.2165(b)(12) and 620.4(c); renumbering existing § 620.5(l) through (n) as (i) through (k); and changing references in § 620.21(a)(3)(i) of our rules from § 620.5(j)("Transactions with senior officers and directors") to § 620.6(e) and § 620.5(k)("Involvement in certain legal proceedings") to § 620.6(f).

B. Enhanced Disclosures of Senior Officer Compensation [§ 620.5(i) and new § 620.6(c)]

Existing § 620.5(i) requires that compensation paid to or earned by senior officers be disclosed in the Compensation Table, and include discussion of benefits paid in connection with resignation, retirement, or termination.

In developing this proposed rule, we recognized that:

- Compensation and retirement benefit practices at many System institutions are increasingly more complex and diverse;

- Our current disclosure requirements may not capture all current practices; and

- Disclosures should include a clear discussion of the relationship between the risks and rewards of compensation practices.

Consequently, we believe our disclosure rules should be amended to ensure that all such practices are addressed in an institution's disclosure of senior officer compensation.

In new § 620.6(c)(4), we propose requiring that institutions disclose information related to supplemental executive retirement plans (SERP), if provided to chief executive officers (CEOs), senior officers or other highly compensated employees (collectively, senior officers). If the CEO and senior officers participate solely in pension and retirement plans offered to all employees, the disclosures would not be required. The information to be disclosed would include, at a minimum:

- Funded and unfunded present value of accumulated benefits for all CEO and senior officers' pension and retirement benefit plans, including the SERP.

- Years of credited service for the CEO and for the senior officers.

- Vested and unvested dollar amounts.

We propose that the disclosures be included in a separate pension and retirement benefits table, and that it be presented in the report with the Compensation Table.

In addition to requiring disclosure of SERPs, we propose institutions:

- Include all compensation, benefit and retirement plans when discussing compensation programs;

- Describe the overall risk and reward structure of compensation, benefit and retirements plans; and

- Discuss the link between the CEO's and senior officers' total compensation, as reported, and both the institution's overall performance and the CEO's and senior officers' performance.

In making these disclosures, we would expect an institution to discuss the criteria used in determining its overall performance (e.g., capital and risk management, credit risk and risk exposure to earnings, liquidity management, and compliance with the general financing agreement). Also, we would expect institutions to discuss the benchmarks or other factors used to determine compensation, including incentive-based compensation. Disclosures would be specific to the institution, rather than being general or boilerplate.

We further propose at new § 620.6(c)(3)(ii)(B) that institutions disclose in the Compensation Table the dollar amount of tax reimbursements or tax payments provided by the institution to senior officers. The disclosure would be classified as a perquisite and other personal benefit and would be reported in the period in which payment is made. We are not proposing to change the threshold for perquisite disclosures.

We believe improved transparency and consistency in disclosures of senior officer compensation provides meaningful and complete disclosure to members-owners and investors. Enhanced disclosures assist members-owners and investors in making informed decisions regarding the financial condition and operations of the institution.

We also propose adding a new § 619.9335 to our general definition rules to define SRP and SERP. A SRP or SERP would be defined to mean a nonqualified retirement plan that provides benefits above and beyond those covered by other retirement plans for all employees, and that is funded in whole or in part by the institution.

C. Compensation Committee Responsibilities [§§ 620.31 and 630.6(b)]

Our existing rules at §§ 620.31 and 630.6(b) require a compensation committee to review and approve the overall compensation programs for senior officers and to review the compensation policies and plans for all employees. Our July 9, 2009, FCA Bookletter, "Compensation Committees" (BL-060), provides guidance on how compensation committees should fulfill their duties. However, we believe it is appropriate to enhance our regulations to include the minimum responsibilities a compensation committee must perform in order to carry out its duties.

Therefore, in order that a compensation committee continues to effectively fulfill its stewardship role, maintain effective and active oversight, and ensure compensation and retirement benefit practices do not jeopardize the institution's safety and soundness, we propose clarifying that the compensation committee is accountable for:

- Monitoring the terms and provisions of the incentive-based compensation programs for senior officers,
- Analyzing the institution's projected long-term obligations for compensation and retirement benefits, and
- Balancing financial rewards to senior officers against the risks to the institution.

The proposed rule would amend our regulations at §§ 620.31(b) and 630.6(b)(2) to enhance compensation committee responsibilities to emphasize that the committee must ensure that:

- CEO and senior officers' compensation promotes the continued safety and soundness of the institution and supports the institution's long-term business strategy and goals,
- Risks to the institution and the financial rewards to the CEO and senior officers are balanced (e.g., compensation and benefits are not excessive relative to the results of operations and financial condition of the institution),
- The institution's projected total long-term compensation and retirement obligations for the CEO and senior officers are analyzed, and
- The compensation of employee groups, other than the CEO and senior officers, do not pose an imprudent risk to the institution (e.g., loan officers).

In addition, we emphasize that compensation committees should ensure that incentive-based compensation programs:

- Are not unreasonable or disproportionate to the services performed, and

- Are structured so that the payout schedule considers the potential for future losses or risks to the institution from services performed in the current period.

Under the proposed rule, the compensation committee would be required to document in meeting minutes its actions related to the proposed enhanced responsibilities. Documenting its actions would facilitate board review of how the committee carried out its responsibilities and provide the current committee with an understanding of prior committee actions.

For organizational reasons, we propose moving the requirements that all compensation committee members must be members of the board of directors and that the compensation committee report only to the board. The requirements would be moved to the section that discusses the formation of a compensation committee. Also, we propose replacing "function" with "perform its duties" in §§ 620.31(c) and 630.6(b)(3) for clarification.

D. Notice to Shareholders [§§ 620.10, 620.11, and 620.15]

In FCA Board Policy Statement, "Cooperative Operating Philosophy – Serving the Members of Farm Credit System Institutions,"[8] (FCA-PS-80) the FCA reaffirmed its commitment to the cooperative structure and its values and practices, including regular and relevant communication with members. As such, we believe that certain events may be of such significance or materiality to warrant communication to members-owners throughout the institution's operating cycle. We believe that timely and transparent communication to members encourages their continued participation in the ownership, control and management of their institution.

Existing §§ 620.15 and 620.17 require that System institutions provide notice to shareholders when the institution is not in compliance with minimum permanent capital standards. This notice is a supplement to annual and quarterly reporting requirements.

In a similar manner, we propose adding a requirement in § 620.15 that significant events or circumstances occurring in interim or intervening periods be communicated to shareholders through separate notice. As proposed, notices would be made as soon as possible, but not later than 90 calendar days after occurrence. As an alternative, we propose allowing the institution to issue the notice within its quarterly report, with prominent disclosure at the front of the report.

The proposed rule would allow institutions to distribute the notice via electronic distribution (Web site) or by publication with circulation wide enough to be reasonably assured that all shareholders have timely access to the information. Also, we propose that the notice be provided to the FCA at the same time it is distributed to shareholders and that the notice be dated and signed.

The proposed rule would include a list of events that must, at a minimum, be reported. If the event would be a "significant" change to a compensation, retirement, benefit or capitalization plan, significance would be based on the change to the individual plan and not the impact of the change to the institution as a whole.

As a related change to our rules, we propose consolidating the current contents of §§ 620.15 and 620.17 on notices regarding permanent capital into § 620.17. This change would allow the placement of the above proposed notice of significant or material events to be located in § 620.15 while preserving existing requirements on notices for permanent capital. We believe the proposed consolidation would add clarity to our rules by keeping like subject matters together and removing redundant language. It is not intended that the meaning and requirements for permanent capital notices be changed.

To conform our regulations in § 620.10, “Preparing the quarterly report,” with the proposed notice of significant or material events, we propose adding a new paragraph (c) to existing § 620.10. The proposed addition would clarify that the quarterly report may be used for notices to shareholders, except minimum permanent capital notices. We also propose adding a similar provision to § 620.11 on contents of quarterly reports, but including a proposed requirement that notices included in the quarterly report be located at the front of the report. We believe this proposed requirement preserves the objective of the notices, which is that members-owners receive timely and transparent communication of significant and material events.

E. <u>Disclosure of Supplemental Retirement Plans to Employees, Exclusive of the CEO and Senior Officers [§ 620.5(e)]</u>

We propose adding a new paragraph (4) to existing § 620.5(e) that would require disclosure of the institution’s obligations related to a SRP to employees, exclusive of any plan provided to the CEO and senior officers. The disclosure would include, at a minimum:

- A description of the plan;
- Funded and unfunded obligations of the plan; and
- Vested and unvested dollar amounts.

We believe that by disclosing an institution’s current and future supplemental benefit obligations, shareholders and investors will have a more complete understanding of the related liabilities and commitments, both on- and off-balance sheet.

F. <u>Nonbinding, Advisory Vote by Shareholders on Senior Officer Compensation [§§ 611.100, 620.5(a) and 630.20(i); new §§ 611.360, 611.410, and 620.6(c)(6)]</u>

Our existing regulations do not require a nonbinding, advisory vote by an institution’s shareholders on senior officer compensation. However, in FCA Informational Memorandum, “Serving the Members of Farm Credit System Institutions” (IM), dated November 4, 2010, we noted that boards of directors can encourage member participation in the management and control of the institution by engaging members as owners and communicating with members. The IM highlighted our belief that effective boards use information obtained from members to establish strategic direction for their institutions and to ensure business activities remain member-focused.

We continue to believe that a Government-sponsored enterprise comprised of cooperative institutions should continually strive to operate under high standards in order to achieve the System's public policy mission and encourage member-owner participation in their institution. Therefore, we propose adding a new § 611.410 requiring that Farm Credit banks and associations provide shareholders the opportunity to cast a nonbinding, advisory vote on senior officer compensation.

The proposed § 611.410 advisory vote would be required at banks and associations if either the CEO’s or the aggregate of all senior officers’ compensation, as disclosed in the Compensation Table, increased or decreased by 15 percent or more from the previous reporting period. The vote would not be required if the 15-percent change resulted solely from a change in the CEO or a change in the composition of personnel included in the senior officer group. Also, we propose that associations be required to hold a nonbinding, advisory vote on compensation if 5 percent of their voting shareholders petition for it. We did not propose this additional petition requirement for banks because there are fewer shareholders at the bank level, thereby allowing a few shareholders to control the petition process.

We do not believe the vote would be burdensome to institutions since it would be required only when a 15-percent change in practice has occurred or, for associations, when 5 percent of their voting shareholders petition for the vote. We believe the proposed nonbinding, advisory vote would provide a means for shareholders to clearly express and communicate either their approval or disapproval of compensation practices for senior officers to their institution's board. The board could then use the information, as appropriate, when establishing the institution's strategic direction and ensure that it remains member-focused.

We selected 15 percent as a threshold change in compensation based on the recent range of percentage changes to bank and association CEO's and senior officers' compensation. We consider the 15-percent threshold to be reasonable. We selected 5 percent as the maximum percentage of voting shareholders required to petition their association for the vote because 5 percent is generally accepted as a criteria for assessing significance or materiality.

We are also proposing general procedures for advisory votes in new § 611.360. The proposed procedures would apply to all advisory votes held by an institution including, but not limited to, the proposed advisory vote on compensation. As proposed, advisory votes would be subject to the same confidentiality and security in voting requirements of § 611.340 and would be cast on a one-member, one-vote basis, including votes cast by shareholders of Farm Credit banks. We propose that weighted and cumulative voting not be allowed in advisory votes in order to further the objective of giving equal voice to each shareholder. Also, new § 611.360 would require that institutions develop voting procedures and provide notice to shareholders of any advisory vote and the procedures used in casting the vote. In addition, proposed § 611.360 would permit the advisory votes to be made in-person, by proxy and by mail.

We propose disclosure in the annual report when an advisory vote is held, including disclosure of the results of the vote. We propose adding a new § 620.5(a)(11) to the "Description of business" section of the annual report, requiring a discussion of the types of advisory votes held during the reporting period. We further propose that disclosure of nonbinding, advisory votes on senior officer compensation be included with senior officer compensation disclosures in new § 620.6(c)(6). This disclosure requirement is proposed to be carried forward into the System-wide report to investors at § 630.20(i).

We propose in new § 611.410(c)(6) that associations disclose that shareholders may petition for an advisory vote, disclose when a petition is received and disclose the results of the petition. The proposal would require that the disclosures be presented with the Compensation Table. We believe that providing the disclosures with the Compensation Table ensures that shareholders are aware of their right to express their opinion on senior officer compensation practices of their associations.

In addition, we propose adding a definition of "advisory vote" at § 611.100(a) to ensure a consistent meaning of the term.

G. Miscellaneous

1. Technical Changes [§§ 611.330(c), 611.400, 620.2(c), 620.4(c), and 620.11]

Our proposed amendments require additional conforming and clarifying changes to other regulatory provisions. Likewise, in the proposed process of consolidating provisions, some regulatory language is proposed to be changed to remove redundancy and enhance clarity. We propose making the following technical and conforming changes:

a. We propose adding a definition for “business day” to § 611.100 to clarify our longstanding position that when our rules reference business day it means a day the institution is open for business, but excludes Federal holidays. As a technical change, we propose renumbering existing § 611.100 paragraphs (a) through (f) as (c) through (h).

b. In subpart D of part 611, we propose revising the name of the subpart from “Rules for Compensation of Board Members” to “Compensation Practices of Farm Credit Banks and Associations.” The change will clarify that the provisions of subpart D relate to various compensation issues at the bank and association level and not just to bank board members. As a conforming change, in § 611.400, we propose revising the name of the section from “Compensation of bank board members” to “Compensation of Farm Credit bank board members” to align terminology to that used in our general definitions of part 619. We also propose replacing the phrase “Farm Credit System bank” with “Farm Credit bank” everywhere it appears to update the section for the same reason.

c. We propose updating the language in § 611.400(b) regarding annual inflationary changes in the statutory salary limit for Farm Credit bank directors. The proposed change would continue to require that we communicate the annual changes to the System, but remove the requirement that we use a bookletter to do so. This will expedite communication of the information.

d. We propose clarifying that the director-nominee disclosures discussed in § 611.330(c)(1) relate to the annual meeting information statement by providing a corresponding rule citation to § 620.21(b).

e. We propose changing the language in § 620.2(c) regarding the electronic delivery of reports to shareholders to clarify that the provision applies only to those reports individually sent to shareholders, not all reports.

f. We propose a minor grammatical change to § 620.4(c) on contents of the annual report by breaking out the sentence into two sentences. No change to the meaning of the paragraph is intended.

g. We propose to reorganize and renumber the existing provisions of § 620.11 to enhance clarity. No changes to the meaning of existing language is proposed, although we propose adding an additional provision to this section on incorporating shareholder notices into a quarterly report, as discussed earlier.

2. <u>Incorporating by Reference [§ 620.2(d)]</u>

We propose changing the language in § 620.2(d), which allows System institutions to incorporate by reference in their reports. The proposed change is to specify that information disclosed in any part of the report may be incorporated by reference in that report unless instructions state otherwise. In a prior rulemaking, we explained that § 620.2(d) allowed institutions to provide information required to be in a specific section of the annual report through a reference to another section of the report.[9] The proposed limit on incorporating by reference would only exist when a rule limits the location of a specific disclosure.

3. <u>Signatures on reports [§ 620.10(c)]</u>

In developing this proposed rule on disclosures in annual and quarterly reports, we noticed an inadvertent omission in the preparation requirements of quarterly reports. While quarterly reports are not required to be mailed to shareholders, we have always expected them to contain signatures and certifications used for other reports. However, existing § 620.10(a) does not clearly state this requirement. Therefore, we propose adding a new paragraph (a)(3) requiring quarterly reports to be signed and financial statements contained in the report to be certified as complete and accurate.

IV. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FCA hereby certifies that the proposed rule would not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, Farm Credit System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

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[1] All references to senior officer(s) in this proposed rule refer to a senior officer as defined in 12 CFR 619.9310.

[2] Pub. L. 92-181, 85 Stat. 583 (1971), 12 U.S.C. 2001, et seq.

[3] 12 U.S.C. 2252(a)(8), (9) and (10).

[4] Pub. L. 102-552, 106 Stat. 4131 (1992).

[5] Copies of the resolution may be obtained by contacting the FCA.

[6] 75 FR 70619 (Nov. 18, 2010).

[7] These topics include the use of a compensation consultant by an institution's compensation committee and director severance benefits and related payments.

[8] See 75 FR 64728, Oct. 20, 2010.

[9] See 74 FR 28597, June 17, 2009.

List of Subjects

12 CFR Part 611

Agriculture, Banks, banking, Rural areas.

12 CFR Part 612

Agriculture, Banks, banking, Conflict of interests, Crime, Investigations, Rural areas.

12 CFR Part 619

Agriculture, Banks, banking, Rural areas.

12 CFR Part 620

Accounting, Agriculture, Banks, banking, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 630

Accounting, Agriculture, Banks, banking, Organization and functions (Government agencies), Reporting and recordkeeping requirements, Rural areas.

For the reasons stated in the preamble, parts 611, 612, 619, 620, and 630 of chapter VI, title 12 of the Code of Federal Regulations are proposed to be amended as follows:

PART 611--ORGANIZATION

1. The authority citation for part 611 is revised to read as follows:

Authority: Secs. 1.2, 1.3, 1.4, 1.5, 1.13, 2.0, 2.1, 2.2, 2.10, 2.11, 2.12, 3.0, 3.1, 3.2, 3.21, 4.12, 4.12A, 4.15, 4.20, 4.21, 5.9, 5.17, 6.9, 6.26, 7.0-7.13, 8.5(e) of the Farm Credit Act (12 U.S.C. 2002, 2011, 2012, 2013, 2021, 2071, 2072, 2073, 2091, 2092, 2093, 2121, 2122, 2123, 2142, 2183, 2184, 2203, 2208, 2209, 2243, 2252, 2278a-9, 2278b-6, 2279a-2279f-1, 2279aa-5(e)); secs. 411 and 412 of Pub. L. 100-233, 101 Stat. 1568, 1638; sec. 414 of Pub. L. 100-399, 102 Stat. 989, 1004.

Subpart A--General

2. Section 611.100 is amended by:

a. Redesignating existing paragraphs (a) through (f) as paragraphs (c) through (h), respectively; and

b. Adding new paragraphs (a) and (b) to read as follows:

§ 611.100 Definitions.

*** * * * ***

(a) *Advisory vote* means a nonbinding vote by the voting stockholders on certain events of the institution, including compensation practices.

(b) *Business day* means a day the institution is open for business, excluding the legal public holidays identified in 5 U.S.C. 6103(a).

*** * * * ***

Subpart C--Election of Directors and Other Voting Procedures

§ 611.330 [Amended]

3. Section 611.330 is amended by:

a. Removing the reference "§ 620.5(j) and (k)" and adding in its place, the reference, "§ 620.6(e) and (f)" in the first sentence of paragraphs (b)(1) and (b)(2); and

b. Adding the words "in accordance with § 620.21(b)" to the end of paragraph (c)(1).

4. Subpart C is amended by adding a new § 611.360 to read as follows:

§ 611.360 Stockholder advisory votes.

(a) Each Farm Credit bank and association must establish and maintain written procedures to implement advisory votes. The procedures, at a minimum, must:

(1) Identify the subject of the advisory vote.

(2) Establish the timing, manner, and notice of the vote.

(i) If the vote will be held in connection with a stockholder meeting or director election, notice of the advisory vote must be part of the Annual Meeting Information Statement, pursuant to § 620.21(d).

(ii) The vote may be in-person, by proxy, or by mail, or any combination thereof.

(3) For associations, explain the process for petitioning for an advisory vote.

(b) Advisory votes are subject to the requirements of § 611.340 and the confidential voting provisions of section 4.20 of the Act (12 U.S.C. 2208).

(c) Advisory votes must be cast using a "one-member, one-vote" voting scheme and are not subject to the provisions in § 615.5230 allowing weighted, cumulative, and other voting schemes.

Subpart D--Compensation Practices of Farm Credit Banks and Associations

5. Revise the heading of subpart D to read as set forth above.

§ 611.400 [Amended]

6. Section 611.400 is amended by:

a. Removing the words "Farm Credit System bank" and adding in their place "Farm Credit bank" in paragraphs (a) and (d)(1); and

b. Removing the words "distribute a bookletter to all FCS banks that communicates" and adding in their place the word "communicate" in the last sentence of paragraph (b).

7. Subpart D is amended by adding a new § 611.410 to read as follows:

§ 611.410 Compensation of senior officers.

(a) If compensation for the chief executive officer either increases or decreases 15 percent or more from the previous reporting period, then the bank or association must present the compensation to voting stockholders for an advisory vote. Such advisory vote must be held in accordance with the provisions of § 611.360. Advisory votes on compensation resulting solely from a change in the chief executive officer during the reporting period are not required.

(b) If senior officer compensation, as reported in the aggregate, either increases or decreases 15 percent or more from the previous reporting period, then the bank or association must present the compensation to voting stockholders for an advisory vote. Such advisory vote must be held in accordance with the provisions of § 611.360. Advisory votes on compensation resulting solely from a change in senior officers included in the aggregate during the reporting period are not required.

(c) Each association must hold an advisory vote on compensation paid to chief executive officers, or senior officers in the aggregate, in accordance with the provisions of § 611.360 when 5 percent of the association's voting stockholders petition for an advisory vote.

(d) Each association must disclose in its annual report to shareholders the authority to petition for an advisory vote on senior officer compensation. The disclosure must also state if a petition was submitted during the reporting period, disclosing if it was certified and a vote held and, if applicable, the results of the vote.

PART 612--STANDARDS OF CONDUCT AND REFERRAL OF KNOWN OR SUSPECTED CRIMINAL VIOLATIONS

8. The authority citation for part 612 continues to read as follows:

Authority: Secs. 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2243, 2252, 2254).

Subpart A--Standards of Conduct

§ 612.2145 [Amended]

9. Section 612.2145 is amended by removing the reference "§ 620.5(k)" and adding in its place, the reference "§ 620.6 (f)" in paragraph (a)(2).

§ 612.2155 [Amended]

10. Section 612.2155 is amended by removing the reference "§ 620.5 (k)" and adding in its place, the reference "§ 620.6 (f)" in paragraph (a)(2).

§ 612.2165 [Amended]

11. Section 612.2165 is amended by removing the reference "§ 620.5" and adding in its place "§§ 620.5 and 620.6" in paragraph (b)(12).

PART 619--DEFINITIONS

12. The authority citation for part 619 is revised to read as follows:

Authority: Secs. 1.4, 1.5, 1.7, 2.1, 2.2, 2.4, 2.11, 2.12, 3.1, 3.2, 3.21, 4.9, 5.9, 5.17, 5.19, 7.0, 7.1, 7.6, 7.8 and 7.12 of the Farm Credit Act (12 U.S.C. 2012, 2013, 2015, 2072, 2073, 2075, 2092, 2093, 2122, 2123, 2142, 2160, 2243, 2252, 2254, 2279a, 2279a-1, 2279b, 2279c-1, 2279f); sec. 514 of Pub. L. 102-552, 106 Stat. 4102.

13. Part 619 is amended by adding a new § 619.9335 to read as follows:

§ 619.9335 Supplemental retirement plan or supplemental executive retirement plan.

A nonqualified retirement plan that provides benefits in addition to those covered by other retirement plans for all employees and funded in whole or part by a Farm Credit bank or association.

PART 620--DISCLOSURE TO SHAREHOLDERS

14. The authority citation for part 620 is revised to read as follows:

Authority: Secs. 4.3, 4.3A, 4.19, 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2154, 2154a, 2207, 2243, 2252, 2254); sec. 424 of Pub. L. 100-233, 101 Stat. 1568, 1656; sec. 514 of Pub. L. 102-552, 106 Stat. 4102.

Subpart A--General

15. Section 620.2 is amended by revising paragraphs (c) and (d) to read as follows:

§ 620.2 Preparing and filing reports.

*** * * * ***

(c) The reports sent to shareholders must comply with the requirements of § 620.3 of this part and shareholders must agree to electronic delivery of those reports.

(d) Information in any part of a report may be incorporated by reference in answer or partial answer to any other item of the report, unless instructions for the report state otherwise.

*** * * * ***

Subpart B--Annual Report to Shareholders

16. Section 620.4 is amended by revising paragraph (c) to read as follows:

§ 620.4 Preparing and providing the annual report.

*** * * * ***

(c) The report must contain, at a minimum, the information required by §§ 620.5 and 620.6. In addition, the report must contain such other information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading.

17. Section 620.5 is amended by:

a. Adding new paragraphs (a)(11) and (e)(4);

b. Revising paragraph (h);

c. Removing paragraphs (i), (j), and (k); and

d. Redesignating existing paragraphs (l), (m), and (n) as paragraphs (i), (j), and (k), respectively, to read as follows:

§ 620.5 Contents of the annual report to shareholders.

*** * * * ***

(a) *Description of business.*

*** * * * ***

(11) The types of advisory votes held during the reporting period and the results of the vote(s).

*** * * * ***

(e) *Description of liabilities.*

*** * * * ***

(4) Describe any supplemental retirement plans funded by the institution on behalf of employees whose benefits are not included in the Pension Benefits Table in § 620.6(c) of this part. Disclose the present value of the aggregate accumulated benefits of funded, unfunded, and unvested obligations related to the plan(s).

*** * * * ***

(h) *Directors and senior officers.* In a separate section of the annual report, make the disclosures required in § 620.6 of this part.

*** * * * ***

18. Subpart B is amended by adding a new § 620.6 to read as follows:

§ 620.6 Disclosures in the annual report to shareholders relating to directors and senior officers.

(a) *General.*

(1) List the names of all directors and senior officers of the institution, indicating the position title and term of office of each director, and the position, title, and date each senior officer commenced employment in his or her current position.

(2) Briefly describe the business experience during the past 5 years of each director and senior officer, including each person's principal occupation and employment during the past 5 years.

(3) For each director and senior officer, list any other business interest where the director or senior officer serves on the board of directors or as a senior officer. Name the position held and state the principal business in which the business is engaged.

(b) *Compensation of directors*. Describe the arrangements under which directors of the institution are compensated for all services as a director (including total cash compensation and noncash compensation). Noncash compensation with an annual aggregate value of less than $5,000 does not have to be reported. State the total cash and reportable noncash compensation paid to all directors as a group during the last fiscal year. For the purposes of this paragraph, disclosure of compensation paid to and days served by directors applies to any director who served in that capacity at any time during the reporting period. If applicable, describe any exceptional circumstances justifying the additional director compensation as authorized by § 611.400(c) of this chapter. For each director, state:

(1) The number of days served at board meetings;

(2) The total number of days served in other official activities, including any board committee(s);

(3) Any additional compensation paid for service on a board committee, naming the committee; and

(4) The total cash and noncash compensation paid to each director during the last fiscal year. Reportable compensation includes cash and the value of noncash items provided by a third party to a director for services rendered by the director on behalf of the reporting Farm Credit institution. Noncash compensation with an annual aggregate value of less than $5,000 does not have to be reported.

(c) *Compensation of senior officers*. Disclose the information on senior officer compensation and compensation plans as required by this paragraph. The institution must disclose the total amount of compensation paid to senior officers in substantially the same manner as the tabular form specified in the Summary Compensation Table (Compensation Table), located in paragraph (c)(3) of this section.

(1) For each of the last 3 completed fiscal years, report the total amount of compensation paid and the amount of each component of compensation paid to the institution's chief executive officer (CEO), naming the individual. If more than one person served in the capacity of CEO during any given fiscal year, individual compensation disclosures must be provided for each CEO.

(2) For each of the last 3 completed fiscal years, report the aggregate amount of compensation paid, and the components of compensation paid, to all senior officers as a group, stating the number of officers in the group without naming them.

(i) If applicable, when any employee who is not a senior officer has annual compensation at a level that is among the five highest paid by the institution during the reporting period, include the highly compensated employee(s) in the aggregate number and amount of compensation reported in the Compensation Table.

(ii) The report containing the aggregate compensation disclosure must include a statement that disclosure of information on the total compensation paid during the last fiscal year to any senior officer, or to any other employee included in the aggregate, is available and will be disclosed to shareholders of the institution and shareholders of related associations (if applicable) upon request. This statement must be located directly beneath the Compensation Table.

(3) The institution must complete the Compensation Table, or something substantially similar, according to the following instructions:

Summary Compensation Table

			Annual			
Name of individual or number in group (a)	Year (b)	Salary (c)	Bonus (d)	Deferred/ perquisite (e)	Other (f)	Total (g)
CEO	20XX 20XX 20XX	$	$	$	$	$
Aggregate No. of Senior Officers (& other highly compensated employees, if applicable) (X) (X) (X)	20XX 20XX 20XX					

(i) Amounts shown as "Salary" (column (c)) and "Bonus" (column (d)) must reflect the dollar value of salary and bonus earned by the senior officer during the fiscal year. Amounts contributed during the fiscal year by the senior officer pursuant to a plan established under section 401(k) of the Internal Revenue Code, or similar plan, must be included in the salary column or bonus column, as appropriate. If the amount of salary or bonus earned during the fiscal year is not calculable by the time the report is prepared, the reporting institution must provide its best estimate of the compensation amount(s) and disclose that fact in a footnote to the table.

(ii) Amounts shown as "deferred/perquisites" (column (e)) must reflect the dollar value of other annual compensation not properly categorized as salary or bonus, including but not limited to:

(A) Deferred compensation earned during the fiscal year, whether or not paid in cash; or

(B) Perquisites and other personal benefits, including the value of noncash items, unless the annual aggregate value of such perquisites is less than $5,000. Reportable perquisites include cash and the value of noncash items provided by a third party to a senior officer for services rendered by the officer on behalf of the reporting institution. Reportable other personal benefits include the dollar value of any tax reimbursement provided by the institution.

(iii) Compensation amounts reported under the category "Other" (column (f)) must reflect the dollar value of all other compensation not properly reportable in any other column. Items reported in this column must be specifically identified and described in a footnote to the table, including compensation relating to pensions and defined benefit plans that may also be reported in the "Pension Benefits Table" at paragraph (c)(4) of this section. "Other" compensation includes, but is not limited to:

(A) The amount paid to the senior officer pursuant to a plan or arrangement in connection with the resignation, retirement, or termination of such officer's employment with the institution;

(B) The amount of contributions by the institution on behalf of the senior officer to a vested or unvested defined contribution plan unless the plan is made available to all employees on the same basis.

(iv) Amounts displayed under "Total" (column (g)) shall reflect the sum total of amounts reported in columns (c), (d), (e), and (f).

(4) If the institution provides a defined benefit plan or a supplemental executive retirement plan (SERP) to its senior officers, the institution must complete the following Pension Benefits Table, or something substantially similar, for each plan according to the following instructions:

Pension Benefits Table

		Annual			
Name of individual	Years of credited service	Funded	Unfunded	Unvested	Total
CEO Senior Officers as a Group (<u>& other highly compensated employees, if applicable</u>)		$	$	$	$

(i) Report separately the present value of accumulated benefits for the CEO and the senior officer group.

(ii) Report the number of credited years of service in "Years of credited service" column.

(iii) Report the amount of the plan(s) that is unfunded in "Unfunded" column.

(iv) Report any off-balance sheet commitments, such as benefits earned but not yet vested, in the "unvested" column.

(v) Report the sum of the funded, unfunded, and unvested columns in the "Total" column.

(5) Provide a description of all compensation, retirement, incentive, performance, and other benefit plans (plans) pursuant to which cash or noncash compensation was paid or distributed during the last fiscal year, or is proposed to be paid or distributed in the future for performance during the last fiscal year, to those individuals included in the Compensation Table. The description of each plan must include, but not be limited to:

(i) A summary of how each plan operates and who is covered by the plan. The summary must include the criteria used to determine amounts payable, including any performance formula or measure, as well as the time period over which the measurement of compensation will be determined, payment schedules, and any material amendments to the plan during the last fiscal year.

(ii) The overall risk and reward structure of the plan as it relates to senior officers' compensation. The description must include, at a minimum, how each plan is compatible with and promotes the institution's goals and business strategy and the mission as a Government-sponsored enterprise.

(iii) A discussion of the relationship between the CEO and senior officers' compensation to the reporting institution's overall performance. The disclosure must also discuss the relationship between the CEO's and senior officers' compensation to their performance.

(6) In the same vicinity as the Compensation Table, discuss any advisory votes that were held under the provisions of § 611.410 of this chapter during the reporting period and the results of the vote(s). For associations, include a discussion of whether or not the vote resulted from a shareholder petition. Each association must disclose in this same location the authority of shareholders to petition for an advisory vote on CEO and senior officer compensation.

(7) Associations may disclose the information required by paragraph (c) of this section in the Annual Meeting Information Statement (AMIS) pursuant to subpart E of this part. Associations exercising this option must include a reference in the annual report stating that the senior officer compensation information is included in the AMIS and that the AMIS is available for public inspection at the reporting association offices pursuant to § 620.2(b).

(d) *Travel, subsistence, and other related expenses*.

(1) Briefly describe your policy addressing reimbursements for travel, subsistence, and other related expenses as it applies to directors and senior officers. The report shall include a statement that a copy of the policy is available to shareholders of the institution and shareholders of related associations (if applicable) upon request.

(2) For each of the last 3 fiscal years, state the aggregate amount of reimbursement for travel, subsistence, and other related expenses for all directors as a group.

(e) *Transactions with senior officers and directors*.

(1) State the institution's policies, if any, on loans to and transactions with officers and directors of the institution.

(2) *Transactions other than loans*. For each person who served as a senior officer or director on January 1 of the year following the fiscal year of which the report is filed, or at any time during the fiscal year just ended, describe briefly any transaction or series of transactions other than loans that occurred at any time since the last annual meeting between the institution and such person, any member of the immediate family of such person, or any organization with which such person is affiliated.

(i) For transactions relating to the purchase or retirement of preferred stock issued by the institution, state the name of each senior officer or director that held preferred stock issued by the institution during the reporting period, the current amount of preferred stock held by the senior officer or director, the average dividend rate on the preferred stock currently held, and the amount of purchases and retirements by the individual during the reporting period.

(ii) For all other transactions, state the name of the senior officer or director who entered into the transaction or whose immediate family member or affiliated organization entered into the transaction, the nature of the person's interest in the transaction, and the terms of the transaction. No information need be given where the purchase price, fees, or charges involved were determined by competitive bidding or where the amount involved in the transaction (including the total of all periodic payments) does not exceed $5,000, or the interest of the person arises solely as a result of his or her status as a stockholder of the institution and the benefit received is not a special or extra benefit not available to all stockholders.

(3) *Loans to senior officers and directors*.

(i) To the extent applicable, state that the institution (or in the case of an association that does not carry loans to its senior officers and directors on its books, its related bank) has had loans outstanding during the last full fiscal year to date to its senior officers and directors, their immediate family members, and any organizations with which such senior officers or directors are affiliated that:

(A) Were made in the ordinary course of business; and

(B) were made on the same terms, including interest rate, amortization schedule, and collateral, as those prevailing at the time for comparable transactions with other persons.

(ii) To the extent applicable, state that no loan to a senior officer or director, or to any organization affiliated with such person, or to any immediate family member who resides in the same household as such person or in whose loan or business operation such person has a material financial or legal interest, involved more than the normal risk of collectability; provided that no such statement need be made with respect to any director or senior officer who has resigned before the time for filing the applicable report with the Farm Credit Administration (but in no case later than the actual filing), or whose term of office will expire or terminate no later than the date of the meeting of stockholders to which the report relates.

(iii) If the conditions stated in paragraphs (e)(3)(i) and (ii) of this section do not apply to the loans of the persons or organizations specified therein, with respect to such loans state:

(A) The name of the officer or director to whom the loan was made or to whose relative or affiliated organization the loan was made.

(B) The largest aggregate amount of each indebtedness outstanding at any time during the last fiscal year.

(C) The nature of the loan(s);

(D) The amount outstanding as of the latest practicable date.

(E) The reasons the loan does not comply with the criteria contained in paragraphs (e)(3)(i) and (e)(3)(ii) of this section.

(F) If the loan does not comply with paragraph (e)(3)(i)(B) of this section, the rate of interest payable on the loan and the repayment terms.

(G) If the loan does not comply with paragraph (e)(3)(ii) of this section, the amount past due, if any, and the reason the loan is deemed to involve more than a normal risk of collectability.

(f) *Involvement in certain legal proceedings*. Describe any of the following events that occurred during the past 5 years and that are material to an evaluation of the ability or integrity of any person who served as director or senior officer on January 1 of the year following the fiscal year for which the report is filed or at any time during the fiscal year just ended:

(1) A petition under the Federal bankruptcy laws or any State insolvency law was filed by or against, or a receiver, fiscal agent, or similar officer was appointed by a court for the business or property of such person, or any partnership in which such person was a general partner at or within 2 years before the time of such filing, or any corporation or business association of which such person was a senior officer at or within 2 years before the time of such filing;

(2) Such person was convicted in a criminal proceeding or is a named party in a pending criminal proceeding (excluding traffic violations and other misdemeanors);

(3) Such person was the subject of any order, judgment, or decree, not subsequently reversed, suspended, or vacated, by any court of competent jurisdiction, permanently or temporarily enjoining or otherwise limiting such person from engaging in any type of business practice.

Subpart C--Quarterly Report

19. Section 620.10 is amended by:
a. Revising paragraph (a); and
b. Adding a new paragraph (c) to read as follows:

§ 620.10 Preparing the quarterly report.

(a) Each institution of the Farm Credit System must:

(1) Prepare and send to the Farm Credit Administration an electronic copy of its quarterly report within 40 calendar days after the end of each fiscal quarter, except that no report need be prepared for the fiscal quarter that coincides with the end of the fiscal year of the institution;

(2) Publish a copy of its quarterly report on its Web site when it electronically sends the report to the Farm Credit Administration; and

(3) Ensure the report complies with the applicable provisions of §§ 620.2 and 620.3 of this part.

*** * * * ***

(c) Institutions may use the quarterly report to deliver any notice required under § 620.15 of this part. Notices required under § 620.17 must be issued separately from the quarterly report, unless otherwise authorized by the Farm Credit Administration.

20. Section 620.11 is amended by:

a. Revising the introductory text of paragraph (b), paragraphs (c) and (d); and

b. Removing paragraphs (e) and (f) to read as follows:

§ 620.11 <u>Content of quarterly report to shareholders</u>.

*** * * * ***

(b) *<u>Rules for condensation</u>*. For purposes of this section, major captions to be provided in the financial statements are the same as those provided in the financial statements contained in the institution's annual report to shareholders, except that the financial statements included in the quarterly report may be condensed into major captions in accordance with the rules prescribed under this paragraph. If any amount that would otherwise be required to be shown by this subpart with respect to any item is not material, it need not be separately shown. The combination of insignificant items is permitted.

*** * * * ***

(c) *<u>Required content</u>*. A quarterly report must, at a minimum, contain the following items:

(1) *<u>Management's discussion and analysis of financial condition and results of operations</u>*. Discuss material changes, if any, to the information provided to shareholders pursuant to § 620.5(g) that have occurred during the periods specified in paragraphs (c)(2)(i) and (ii) of this section. Such additional information as is needed to enable the reader to assess material changes in financial condition and results of operations between the periods specified in paragraphs (c)(2)(i) and (ii) of this section shall be provided.

(i) *<u>Material changes in financial condition</u>*. Discuss any material changes in financial condition from the end of the preceding fiscal year to the date of the most recent interim balance sheet provided. If the interim financial statements include an interim balance sheet as of the corresponding interim date of the preceding fiscal year, any material changes in financial conditions from that date to the date of the most recent interim balance sheet provided also shall be discussed. If discussions of changes from both the end and the corresponding interim date of the preceding fiscal year are required, the discussions may be combined at the discretion of the institution.

(ii) *<u>Material changes in results of operations</u>*. Discuss any material changes in the institution's results of operations with respect to the most recent fiscal year-to-date period for which an income statement is provided and the corresponding year-to-date period of the preceding fiscal year. Such discussion also shall cover material changes with respect to that fiscal quarter and the corresponding fiscal quarter in the preceding fiscal year. In addition, if the institution has elected to provide an income statement for the 12-month period ended as of the date of the most recent interim balance sheet provided, the discussion also shall cover material changes with respect to that 12-month period and the 12-month period ended as of the corresponding interim balance sheet date of the preceding fiscal year.

(2) *<u>Interim financial statements</u>*. The following financial statements must be provided:

(i) An interim balance sheet as of the end of the most recent fiscal quarter and as of the end of the preceding fiscal year. A balance sheet for the comparable quarter of the preceding fiscal year is optional.

(ii) Interim statements of income for the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the comparable periods for the previous fiscal year.

(iii) Interim statements of changes in protected borrower capital and at-risk capital for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the comparable period for the preceding fiscal year.

(iv) For banks, interim statements of cash flows for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the comparable period for the preceding fiscal year. For associations, interim statements of cash flows are optional.

(3) *<u>Other related financial items</u>*. State that the financial statements were prepared under the oversight of the audit committee. The interim financial information need not be audited or reviewed by a qualified public accountant or external auditor prior to filing. If, however, a review of the data is made in accordance with the established professional standards and procedures for such a review, the institution may state that a qualified public accountant or external auditor has performed such a review under the supervision of the institution's audit committee. If such a statement is made, the report of a qualified public accountant or external auditor on such review must accompany the interim financial information.

(d) *Notices.* Institutions using the quarterly report to deliver any notice required under § 620.15 of this part must put the notice information at the beginning of the quarterly report. The notice must be conspicuous and may not be part of any footnotes to the quarterly report. Notices that are made part of the quarterly report must comply with the provisions of both this section and § 620.15.

Subpart D--Notice to Shareholders

21. Subpart D is amended by revising §§ 620.15 and 620.17 to read as follows:

§ 620.15 Notice of significant or material events.

(a) When a Farm Credit bank or association determines that it has a significant or material event, the institution must prepare and provide to its shareholders and the Farm Credit Administration a notice disclosing the event(s).

(1) Events covered under this provision include significant events defined in § 620.1(q) and material events defined in § 620.1(h).

(2) At a minimum, a notice must be issued for significant or material events involving compensation, retirement and benefit plans, capitalization plans or bylaws, results of shareholder votes, early director departures, unplanned departure of a senior officer, letters of intent to merge, changes in external auditors, and reportable Farm Credit Administration supervisory and enforcement actions.

(b) A notice issued under this section must be made as soon as possible, but not later than 90 days after occurrence of the event.

(1) Each institution must electronically provide the notice to the Farm Credit Administration at the same time as distribution of the notice to shareholders.

(2) Delivery of the notice to shareholders may be accomplished by direct communications with the shareholders, posting the notice on the institution's Web site, as part of the quarterly report to shareholders, or by publishing the notice in any publication with circulation wide enough to reasonably assure that all of the institution's shareholders have access to the information in a timely manner.

(c) Every notice must be dated and signed in a manner similar to the requirements of § 620.3(b).

(d) The information required to be included in a notice issued under this section must be conspicuous, easily understandable, complete, accurate, and not misleading.

§ 620.17 Special notice provisions for events related to minimum permanent capital.

(a) When a Farm Credit bank or association determines that it is not in compliance with the minimum permanent capital standard prescribed under § 615.5205 of this chapter, that institution must prepare and provide to its shareholders and the Farm Credit Administration a notice stating that the institution has initially determined it is not in compliance with minimum permanent capital standards. Such notice must be given within 30 days following the month end.

(b) When notice is given under paragraph (a) of this section, the institution must also notify its shareholders and the Farm Credit Administration when the institution's permanent capital ratio decreases by one half of 1 percent or more from the level reported in the original notice, or from that reported in a subsequent notice provided under this paragraph. This notice must be given within 45 days following the end of every quarter at which the institution's permanent capital ratio decreases as specified.

(c) Each institution required to prepare a notice under paragraphs (a) or (b) of this section shall provide the notice to shareholders or publish it in any publication with circulation wide enough to be reasonably assured that all of the institution's shareholders have access to the information in a timely manner. The information required to be included in this notice must be conspicuous, easily understandable, and not misleading.

(d) A notice, at a minimum, shall include:

(1) A statement that:

(i) Briefly describes the regulatory minimum permanent capital standard established by the Farm Credit Administration and the notice requirement of paragraph (a) of this section;

(ii) Indicates the institution's current level of permanent capital; and

(iii) Notifies shareholders that the institution's permanent capital is below the Farm Credit Administration regulatory minimum standard.

(2) A statement of the effect that noncompliance has had on the institution and its shareholders, including whether the institution is currently prohibited by statute or regulation from retiring stock or distributing earnings or whether the Farm Credit Administration has issued a capital directive or other enforcement action to the institution.

(3) A complete description of any event(s) that may have significantly contributed to the institution's noncompliance with the minimum permanent capital standard.

(4) A statement that the institution is required by regulation to provide another notice to shareholders within 45 days following the end of any subsequent quarter at which the institution's permanent capital ratio decreases by one half of 1 percent or more from the level reported in the notice.

Subpart E--Annual Meeting Information Statements and Other Information to be Furnished in Connection with Annual Meetings and Director Elections

22. Section 620.21 is amended by revising paragraph (a)(3)(i) to read as follows:

§ 620.21 Contents of the information statement.

(a) * * *

(3) * * *

(i) If any transactions between the institution and its senior officers and directors of the type required to be disclosed in the annual report to shareholders under § 620.6(e), or any of the events required to be disclosed in the annual report to shareholders under § 620.6(f) have occurred since the end of the last fiscal year and were not disclosed in the annual report to shareholders, the disclosures required by § 620.6(e) and (f) shall be made with respect to such transactions or events in the information statement. If any material change in the matters disclosed in the annual report to shareholders pursuant to § 620.6(e) and (f) has occurred since the annual report to shareholders was prepared, disclosure shall be made of such change in the information statement.

*** * * * ***

Subpart F--Bank and Association Audit and Compensation Committees

23. Section 620.31 is revised to read as follows:

§ 620.31 Compensation committees.

Each Farm Credit bank and association must establish and maintain a compensation committee by adopting a written charter describing the committee's composition, authorities, and responsibilities in accordance with this section. The compensation committee must report only to the board of directors. All compensation committees will be required to maintain records of meetings, including attendance, for at least 3 fiscal years.

(a) *Composition*. Each compensation committee must consist of at least three members and all committee members must be members of the institution's board of directors. Every member must be free from any relationship that, in the opinion of the board, would interfere with the exercise of independent judgment as a committee member.

(b) *Responsibilities*. It is the responsibility of each compensation committee to review the compensation policies and plans for senior officers and employees and to approve the overall compensation program for senior officers. In fulfilling its responsibilities, the compensation committee must document that it:

(1) Analyzed the institution's projected long-term compensation and retirement benefit obligations and determined such obligations are appropriate to the services performed and not excessive.

(2) Reviewed incentive-based compensation programs and payments and determined that they were not unreasonable or disproportionate to the services performed and were structured so the payout schedule considered the potential for future losses or risks to the institution.

(3) Reviewed senior officer compensation, incentive and benefit programs and determined that they support the institution's long-term business strategy, as well as promote safe and sound business practices.

(4) Reviewed compensation programs designed for specific groups of employees, other than senior officers, to ensure the plan(s) pose no imprudent risk to the institution.

(c) *Resources*. Each institution must provide monetary and nonmonetary resources to enable its compensation committee to perform its duties.

PART 630—DISCLOSURE TO INVESTORS IN SYSTEM-WIDE AND CONSOLIDATED BANK DEBT OBLIGATIONS OF THE FARM CREDIT SYSTEM

24. The authority citation for part 630 is revised to read as follows:

Authority: Secs. 4.2, 4.9, 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2153, 2160, 2243, 2252, 2254); sec. 424 of Pub. L. 100-233, 101 Stat. 1568, 1656; sec. 514 of Pub. L. 102-552, 106 Stat. 4102.

Subpart A--General

25. Section 630.6 is amended by revising paragraph (b) to read as follows:

§ 630.6 Funding Corporation committees.

*** * * * ***

(b) *Compensation committee*. The Funding Corporation must establish and maintain a compensation committee by adopting a written charter describing the committee's composition, authorities, and responsibilities in accordance with this section. The compensation committee must report only to the board of directors. The compensation committee will be required to maintain records of meetings, including attendance, for at least 3 fiscal years.

(1) *Composition*. The committee must consist of at least three members and all members must be members of the Funding Corporation’s board of directors. Every compensation committee member must be free from any relationship that, in the opinion of the board, would interfere with the exercise of independent judgment as a committee member.

(2) *Responsibilities*. It is the responsibility of the compensation committee to review the compensation policies and plans for senior officers and employees and to approve the overall compensation program for senior officers. In fulfilling its responsibilities, the compensation committee must document that it:

(i) Analyzed the Funding Corporation’s projected long-term compensation and retirement benefit obligations and determined such obligations are appropriate to the services performed and not excessive.

(ii) Reviewed incentive-based compensation programs and payments and determined that they were not unreasonable or disproportionate to the services performed and were structured so the payout schedule considered the potential for future losses or risks to the Funding Corporation.

(iii) Reviewed senior officer compensation, incentive and benefit programs and determined that they support the Funding Corporation's long-term business strategy and mission, as well as continue to promote safe and sound business practices.

(3) *Resources.* The Funding Corporation must provide monetary and nonmonetary resources to enable its compensation committee to perform its duties.

Subpart B--Annual Report to Investors

26. Section 630.20 is amended by revising paragraph (i) to read as follows:

§ 630.20 Contents of the annual report to investors.

*** * * * ***

(i) *Compensation of directors and senior officers*. State that information on the compensation of directors and senior officers of Farm Credit banks is contained in each bank's annual report to shareholders and that the annual report of each bank is available to investors upon request pursuant to § 630.3(g). State whether advisory votes were held in any of the disclosure entities during the reporting period and the results of such vote.

*** * * * ***

Date: January 12, 2012

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.

77 FR 16485, 03/21/2012

Handbook Mailing HM-12-3

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Parts 611, 612, 619, 620 and 630

RIN 3052-AC41

Compensation, Retirement Programs, and Related Benefits

AGENCY: Farm Credit Administration.

ACTION: Proposed rule; extension of comment period.

SUMMARY: The Farm Credit Administration (FCA, us, we, or our) published a proposed rule to amend our regulations related to Farm Credit System (System) bank and association disclosures to shareholders and investors. The proposed rule would require enhanced reporting of senior officer compensation and retirement programs and reporting to shareholders of significant events that occur between annual reporting periods. The proposed rule would also identify the minimum responsibilities a compensation committee must perform and require that System banks and associations provide for a nonbinding, advisory vote on senior officer compensation. To allow interested parties additional time to submit comments, we are extending the comment period on the proposed rule from March 23, 2012 to April 16, 2012.

DATES: Comments on the proposed rule must be submitted on or before April 16, 2012.

ADDRESSES: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we no longer accept comments submitted by fax. Regardless of the method you use, please do not submit your comments multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send an e-mail to reg-comm@fca.gov.

- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."

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

- Mail: Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Deborah Wilson, Senior Accountant, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434,

or

Laura McFarland, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

On January 23, 2012, the FCA published a proposed rule in the Federal Register seeking public comment on proposed changes to senior officer compensation disclosures and related topics. See 77 FR 3172. The comment period is scheduled to close on March 23, 2012. The FCA received several letters in response to the proposed rule requesting we extend the comment period by 60 days. Many of the commenters explained that the proposed rule was published while System institutions were fully engaged in completion of their annual reports. The commenters emphasized that System institutions have significant interest in the proposed rule and were, therefore, requesting more time to evaluate and comment in a thoughtful and coordinated manner.

The FCA supports public involvement and participation in its regulatory process and invites all interested parties to review and comment on our proposed rule. We balanced the request for more time against the fact that most of the issues in the proposed rule were previously subject to a 120-day comment period under an Advance Notice of Proposed Rulemaking (75 FR 70619, November 18, 2010). We also considered that a related proposed rule on the System Audit Committee (77 FR 8179, February 14, 2012) has a comment period closing April 16. As a result, we are extending the comment period 24 days instead of the requested 60 days to coincide with the related proposed rule.

Date: March 15, 2012

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.

69 FR 12694, 03/17/2004

Handbook Mailing HM-04-5

[6705-01-P]

FARM CREDIT ADMINISTRATION

Systematic Collection of Standardized Loan Data

AGENCY: Farm Credit Administration.

ACTION: Notice with request for comment.

SUMMARY: The Farm Credit Administration (FCA or agency) is seeking public input on the changes it should consider making to its systematic collection of standardized loan data. The agency currently collects basic descriptive information from Farm Credit System (FCS or System) banks and associations, in a standardized format, using the Loan Account Reporting System–Modified (LARS-M). The agency is planning to reengineer its collection of standardized loan data to meet its current and future information needs. In support of this reengineering project, FCA is seeking public comment on changes the agency should consider making to the loan data it collects; what processes and technological approaches to employ when collecting loan data; how to minimize the reporting burden on System institutions while meeting agency needs; and what types of standardized reports to make available to the general public and System institutions.

DATES: Please send your comments to the FCA by May 3, 2004.

ADDRESSES: We encourage you to send comments by electronic mail to "reg-comm@fca.gov" or through the Pending Regulations section of FCA's Web site, "www.fca.gov." You may also send comments to Andrew Jacob, Assistant Director, Office of Policy and Analysis, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090 or by facsimile to (703) 734-5784. You may review copies of all comments we receive at our office in McLean, Virginia.

FOR FURTHER INFORMATION CONTACT:

Gaylon J. Dykstra, Policy Analyst, Office of Policy and Analysis, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4073, TTY (703) 883-4434.

or

Howard Rubin, Senior Attorney, Office of the General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4029, TTY (703) 883-2020.

SUPPLEMENTARY INFORMATION:

I. <u>Background</u>

A. <u>What is LARS-MLoan Data Does FCA Collect</u>?

FCA currently collects certain standardized loan information from FCS banks and associations using the LARS-M. Examples of standardized variables collected include:

1. The date the loan was originated and the date on which it matures;

2. The primary agricultural commodity produced by the borrower;

3. Whether a loan is covered by a government guarantee;

4. If a loan is past due, the number of days the loan payment is delinquent;

5. The risk of the loan based on the uniform classification system as defined in the FCA Examination Manual (EM-320); and

6. Whether the borrower is in bankruptcy or the loan is in foreclosure status.

The agency also obtains direct institution-specific loan data as needed for examination purposes.

B. <u>How Does FCA Use Loan Data</u>?

FCA uses loan information to support its supervision and regulation of System institutions. For supervisory purposes, loan information is important for evaluating portfolio risk associated with agricultural lending and analyzing credit risks in individual agricultural loans. Loan data are also required for monitoring Systemwide trends and emerging vulnerabilities. For regulatory purposes, loan information is used for developing regulations and other public policy actions. FCA also uses loan data in fulfilling reporting requirements and informational requests.

C. <u>Identifying Loan Portfolio Risk</u>

Identification of risks in a loan portfolio is essential to FCA's evaluation of an institution's safety and soundness. Loan portfolio risk reflects individual loan exposures and the combined effects on a portfolio. Risk in individual loans is a function of characteristics associated with a borrower's agricultural operation and financial condition and performance. Examples of loan characteristics include the commodities produced, geographic location, payment history, financial strength, and off-farm income. These types of loan data are important determinants of the credit risk of a loan. Therefore, FCA access to loan data is critical for evaluating portfolio risks of System institutions and the credit risk of individual loans.

D. <u>Monitoring Systemwide Trends</u>

Analyzing Systemwide trends and emerging vulnerabilities is a critical agency activity for monitoring the overall mission accomplishment and ongoing safety and soundness of the FCS. Monitoring Systemwide trends helps FCA identify when risks are impacting the System's agricultural loans. For example, the System may show an overall increase in delinquent loans. Access to loan data allows the agency to analyze this trend and associated characteristics, such as geographic location, commodity linkage, or other commonalities among affected institutions. Similarly, the agency uses loan data to analyze the impact of emerging vulnerabilities, such as food safety concerns, trade disputes, changes in government support programs, shifts in consumer preferences, and climactic events. Using loan data, the agency can better identify vulnerable System loans. Access to loan data increases FCA's understanding of the systemic risks facing the FCS and helps the agency determine if any policy actions are needed.

E. Developing Regulations and Policy

FCA uses loan data to support its regulation of System institutions. For example, loan data provide information needed to evaluate the impact of capital adequacy standards, lending limits, and liquidity requirements. Moreover, access to loan data allows the agency to analyze the effectiveness and results achieved from regulations and policy actions.

F. Fulfilling Reporting Requirements and Responding to Information Requests

The agency is required to periodically provide reports to Congress. The agency also frequently responds to information requests from Congress and others. Ready access to loan data aids FCA in timely and accurately responding to reporting requirements and information requests.

G. Why is FCA Considering ChangingLARS-M its Standardized Collection of Loan Data?

LARS-M was first implemented in 1987 and last revised in 1993. While LARS-M provides FCA with a standardized and centralized collection of loan data, it has not kept pace with changes in financial reporting systems, is incomplete as to loan types, lacks detail, and only allows access to current quarter data. FCA, therefore, believes improvements are needed to fully meet the agency's current and future information needs.

FCA examiners also obtain loan information directly from System institutions on an ad hocas-needed basis for use in conducting examinations, but this information is not standardized or centralized. As a result, directly downloaded data are not useful or available for Systemwide analysis or reporting. More importantly, the downloaded data vary considerably by FCA field office since loan information systems vary across System institutions. Therefore, standardized and centralized collection of loan data would help overcome the variety in electronic loan information systems used by FCS institutions.

II. Objectives of This Project

The objectives of FCA's project to reengineer its standardized collection of loan data from System institutions are to:

1. Determine the appropriate set of loan data to collect on a systematic, centralized, and standardized basis that meets the agency's needs;

2. Streamline the collection process of loan data to enhance reliability, timeliness, and data accuracy;

3. Minimize the reporting burden on System institutions; and

4. Provide appropriate standardized reports to internal and, potentially, external parties.

The reengineering project will address the limitations of the current approach to a standardized collection of loan data. The agency is already considering the data elements it needs to collect on individual loans, including what specific financial information, loan performance data, and other essential information about loan characteristics that are necessary for adequately evaluating portfolio and loan risks. Moreover, the project will also address the agency's need to collect information for all loans made by System institutions. Along with these considerations, the agency is evaluating the data elements needed to model loan performance characteristics through time, such as probability of default, loss severity, and exposures at default. In the future, modeling loan performance may become a key aspect in the evaluation of a System institution's capital adequacy. FCA is also evaluating new technologies to streamline and improve the collection process. This evaluation includes reducing the reporting burden by relying on an efficient process that utilizes information readily available in the different FCS institutions' electronic loan information systems.

FCA is also evaluating the standardized reports the agency currently uses in conducting its supervisory and regulatory programs, including considering the type of reports to make available to the general public and System institutions in light of legal restrictions and other constraints regarding the release of private and sensitive business information used solely for examination purposes.

III. Questions

To augment the agency's experience and expertise with agricultural lending practices and credit analysis, FCA is seeking public input on the changes it should consider making as it reengineers the systematic collection of standardized loan data from System institutions. Specifically, the agency requests comments on:

1. What suggestions do you have regarding loan data elements?

2. What processes and technological approaches to employ to streamline the collection of loan data?

3. How to minimize the reporting burden on System institutions while meeting the agency's informational needs?

4. What standardized reports to make available to the general public and System institutions, considering the need to protect private and proprietary confidential information?

Along with these questions, we welcome any other comments or suggestions the agency should consider as it moves forward with this initiative.

Date: March 12, 2004

Jeanette C. Brinkley,
Secretary,
Farm Credit Administration Board.

77 FR 56571, 09/13/2012

Handbook Mailing HM-12-5

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Parts 604, 611, 612, 619, 620, 621, 622, 623, and 630

RIN 3052-AC65

Unincorporated Business Entities

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, we, or our) is proposing to establish a regulatory framework for Farm Credit System (System) institutions' use of unincorporated business entities (UBEs) organized under State law for certain business activities. For purposes of this proposed rule, a UBE includes limited partnerships (LPs), limited liability partnerships (LLPs), limited liability limited partnerships (LLLPs), limited liability companies (LLCs), and any other unincorporated business entities, such as unincorporated business trusts, organized under State law. This rule does not apply to UBEs that one or more System institutions may establish as Rural Business Investment Companies (RBICs) pursuant to the institutions' authority under the provisions of title VI of the Farm Security and Rural Investment Act of 2002, as amended (FSRIA), and United States Department of Agriculture (USDA) regulations implementing FSRIA. This rule does apply, however, to System institutions that organize UBEs for the express purpose of investing in RBICs.

DATES: Comments on this proposed rule must be submitted on or before November 13, 2012.

ADDRESSES: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we do not accept comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Barry F. Mardock, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia, or from our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Elna Luopa, Senior Corporate Analyst, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434,

or

Wendy Laguarda, Assistant General Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of this proposed rule are to:

- Affirm FCA's authority to regulate and examine the System institutions' use of UBEs, including the authority to impose any conditions FCA deemed necessary and appropriate on UBE business activity, and to take enforcement action against System institutions' activities involving UBEs;
- Prohibit System institutions from using UBEs to engage in direct lending or any activity that exceeds their authority under the Act or circumvents the application of cooperative principles;
- Limit the amount of a System institution's equity investments in UBEs;
- Create a process for FCA review and approval of requests by System institutions to organize or invest in UBEs for certain business activity;
- Establish standards for the proper and adequate disclosure and reporting of System UBE activity; and
- Ensure that the System's use of UBEs remains transparent and free from conflicts of interest.

II. Background

Beginning in the early 1980s, FCA approved joint ventures among System institutions, as well as System institution contractual alliances with non-System entities, that sought to improve the reliability and delivery of authorized products and services to agriculture and rural America. These collaborative initiatives enabled System institutions to provide services and products more efficiently and inexpensively, resulting in improved and less costly services and products to the farmer and rancher System borrowers and rural communities.

Business models and structures have significantly evolved since the 1980s, as more and more States have adopted uniform statutes governing unincorporated, largely limited liability, business structures. The System's use of UBEs has been a logical outgrowth of its earlier collaborative initiatives implemented through joint ventures and alliances. Like these earlier joint initiatives, UBEs enable the System to provide more efficient, less costly services and products to the agricultural or rural community, but through more sophisticated, formal and flexible structures that address ownership rights, management, operations, assumptions of liability, allocation of profits and losses and payment of taxes. Further, UBEs have the added advantage of providing more protection for System stockholders by enabling a System institution to limit its liability to the amount of its equity investment in a UBE.

III. The Statutory Basis for the Proposed Rule

A. System Institutions' Authority

The System's existing investment[1] and incidental powers[2] provide the authorities for System institutions to invest in and form UBEs for certain business activity. Specifically, under § 615.5140(e), System institutions may exercise their investment authorities to invest in "other investments approved by the FCA" provided the funding bank has approved the investment. System investments in UBEs fall under this category, and may be approved by FCA upon a request that explains the risk characteristics of the investment and the System institution's purpose and objectives for making the investment.

Unlike the express authority to organize service corporations under sections 4.25 and 4.28(A) of the Act,[3] no provision under the Act explicitly authorizes System institutions to organize entities under State law to engage in business activity. However, Congress has long encouraged coordinated initiatives by System institutions to provide joint products, services or functions to System borrowers. We note that the farmer-owned, cooperative and jointly liable System, by its very establishment, is designed to accomplish the most efficient and effective delivery system of credit and related services to agriculture and its producers and rural communities. Moreover, various provisions in the Act have authorized or directed System institutions to offer joint products or services. The same year that Congress added the service corporation authority to the Act (1980), it also directed System institutions to establish programs for young, beginning and small (YBS) farmers and ranchers "in coordination with other units of the Farm Credit System serving the territory and with other governmental and private sources of credit."[4] These 1980 additional authorities evidence Congress' intention that System institutions be able to provide coordinated services and products to System borrowers and rural communities using business structures that can best facilitate such efforts.

In fact, System institutions, with FCA approval, have been using their incidental authority to enter into non-corporate joint ventures to promote coordinated and expedient initiatives, which in recent years have included State-chartered UBEs.

This proposed rule will provide a more uniform approval and oversight process for the System's continuing use of UBEs. The rule emphasizes that incidental powers can neither be the basis for broadening or circumventing the limitations and restrictions of a System institution's express powers in carrying on the business of the bank or association nor used to engage in activities that are impermissible under the Act. The delivery of System credit, services and other products will still chiefly be provided by System institutions' direct use of their express powers to serve their eligible borrowers and customers. As a Government-sponsored enterprise (GSE) of cooperative institutions owned and controlled by their member-borrowers, it is essential that System institutions maintain their strong cooperative traditions and reputations.[5]

In recognizing changing business practices through the System's use of UBEs, the preservation of the System's member-focused principles remains paramount. This proposed rule would therefore prohibit System institutions from engaging in direct lending activities or any other activity through UBEs that circumvents the application of cooperative principles such as borrower rights, stock ownership, voting rights or patronage.

Finally, to provide transparency to the public, FCA intends to post on its Web site the name and business purpose of UBEs organized and controlled by one or more System institutions that are approved under this rule.

B. FCA Authority over System Investments in UBEs and UBE Business Activity

Under part C of title V of the Act, FCA has the ability to take an enforcement action against a System institution in connection with its equity investment in and use of a UBE for business activity to ensure an institution's safety and soundness.

IV. Section-by-Section Analysis

A. Unincorporated Business Entities [new §§ 611.1150 through 611.1158]

We propose adding a new subpart J to part 611 that would address the purpose and scope of unincorporated business entities organized or invested in by System institutions. Subpart J includes provisions on: (1) Definitions; (2) FCA's regulatory, examination, enforcement, and assessment authorities; (3) general restrictions and prohibitions on the use of UBEs; (4) notice-only requirements for certain activities conducted through UBEs; (5) FCA's review process for UBEs not meeting the notice-only provisions; (6) ongoing requirements; (7) disclosure and reporting requirements; and (8) transparency and conflict of interest requirements. Subpart J also contains a grandfather provision for those UBEs previously approved by FCA on a case-by-case basis and for those UBEs established under the guidance provided in FCA Bookletter BL-057,[6] which may be rescinded once a final rule becomes effective.

1. Purpose and Scope [new § 611.1150]

Proposed § 611.1150 affirms that System institutions have incidental power as may be necessary or expedient to carry on the business of the bank or association, as applicable. In exercising this incidental power, System institutions may continue to establish UBEs, provided the UBE business activity is necessary or expedient to the System institution's express authorities in carrying on the business of the bank or association and falls within the parameters of the rule.

The proposed rule would apply to any System institution that organizes or invests in a UBE for the delivery of services or functions. This proposed rule also pertains to any System institution that has an equity investment in a System-organized and controlled UBE regardless of the amount of the investment. The proposed rule would also apply to any System institution that is a partner or member of a UBE organized to acquire and manage unusual or complex collateral associated with loans under FCA Bookletter BL-057.

Except as authorized by this rule, System institutions cannot manage, control, or invest in any State-chartered or organized business entity. The proposed rule would not permit System institutions to make equity investments in UBEs that are organized, controlled or managed by a non-System entity (third-party UBE) except as may be approved by FCA under § 615.5140(e) for de minimis and passive investments. Such approvals would be considered outside of this rule.

As previously stated, this rule is not applicable to any UBEs that System institutions may establish as RBICs under their separate statutory authority. System institutions' activities under the RBIC authority must be carried out in accordance with the authority of and regulations issued by USDA.[7]

However, this rule does apply to System institutions that organize UBEs for the express purpose of investing in a RBIC.

2. Definitions [new § 611.1151]

We propose a definitions section in § 611.1151 that defines the following relevant terms used in the proposed rule.

Articles of Formation refers to the relevant State documents on the establishment, ownership, and operation of a UBE and includes registration certificates, charters, articles of organization, partnership agreements, membership or trust agreements, operating, administration or management agreements, fee agreements, or any other documentation on the establishment, ownership or operation of a UBE.

Control[8] distinguishes whether a System institution controls the business activities, operations, and actions of the UBE. Control means that one System institution, directly or indirectly, owns more than 50 percent of the UBE's equity or serves as the general partner[9] of an LLLP or constitutes the sole manager or is the managing member of a UBE. However, under generally accepted accounting principles (GAAP), the power to control may also exist with a lesser percentage of ownership, for example, if a System institution is the UBE's primary beneficiary; exercises significant influence over the UBE; or establishes control under other facts and circumstances in accordance with GAAP.

Under this definition, a System institution also will be deemed to have control over the UBE if it exercises decision-making authority in a principal capacity of the UBE as defined under GAAP.

A System institution must divest its ownership interest or withdraw as a member or partner from any UBE as soon as practicable if, after a System institution organizes or invests in a System-controlled UBE, non-System persons or entities obtain control as defined under GAAP. Alternatively, as soon as practicable the non-System persons or entities must relinquish control as defined under GAAP.

Equity investment means a System institution's contribution of money or assets to the operating capital of a UBE that provides ownership rights in return. The term is meant to include any such contribution of money or assets regardless of the terminology that might be used in an individual State's statute or regulations. The definition of equity investment does not include the costs of organizing a UBE, such as the cost of the articles of formation, attorney fees, filing fees, etc.

System institution refers to each System bank under titles I or III of the Act, each association under title II of the Act, and each service corporation chartered by FCA under section 4.25 of the Act.

Third-party UBE means any UBE that is owned or controlled by one or more non-System persons or entities.

UBE is an acronym for Unincorporated Business Entity. As defined for purposes of this proposed rule, the term "UBE" includes unincorporated business entities that are formally established and maintained through applicable State law, such as limited partnerships, limited liability companies, and business or other trust entities.

UBE Business Activity refers to the delivery of services or functions by a UBE for one or more System institutions.

3. Regulation, Examination, Enforcement, and Assessment Authority [new § 611.1152]

Proposed § 611.1152 affirms that FCA has full regulatory, supervisory, oversight, examination and enforcement authority over System institutions in connection with their equity investments in and control of UBEs and the services and functions that a UBE performs for the System institution. Such authority includes FCA's right to require a System institution to withdraw from a UBE through dissolution or disassociation or to divest of any investment in a UBE. Sections 5.17(a)(5), 5.17(a)(10), and 5.25(a) of the Act, as well as § 615.5354, also give FCA the authority to condition the approval of a System institution's equity investment in a UBE. The FCA's use of these authorities ensures that System institutions providing certain functions and services through State-organized or chartered UBEs remain safe and sound and operate in accordance with law and regulations.

Finally, this proposed section provides that the cost of regulating and examining equity investments in UBEs and the services and functions that UBEs can perform for System institutions will be subject to FCA's assessment authority under section 5.15 of the Act.

4. <u>General Restrictions and Prohibitions on the Use of UBEs</u> [new § 611.1153]

Proposed § 611.1153 sets forth certain general restrictions on any function, service or activity that a System institution(s) conducts through a UBE. These restrictions would ensure that the System continues to operate in a safe and sound manner and that its status as a cooperative system of lending institutions and a GSE is not jeopardized through the use of UBEs.

The first restriction would provide that any business a System institution conducts through a UBE must be necessary or expedient to the business of the System institution. A UBE cannot be used to deliver services or functions or to engage in any activity that a System institution itself could not engage in under the Act or implementing regulations.

A second restriction would protect the integrity of the System's cooperative structure by prohibiting System institutions from engaging in direct lending activities or from engaging in any other activity through the use of a UBE that would circumvent the application of cooperative principles, as determined by FCA, including borrower rights, stock ownership, voting rights or patronage.

A third restriction would ensure that the use of a UBE by a System institution is transparent to the public and free from conflicts of interest. This provision would require that a UBE be held out to the public as a separate or subsidiary entity; the business transactions, accounts and records of the UBE are not commingled with those of the System institution; and all transactions between officers, employees and agents of the UBE and a System institution are conducted at arm's length, in the interest of the System institution, and in compliance with the standards of conduct rules in 12 CFR part 612, subpart A.

A fourth restriction would limit a single System institution from conducting business through a one-member UBE, such as a limited liability company, other than for the limited purposes of: (1) Acquiring and managing unusual or complex collateral associated with loans, as set forth under the guidance of FCA Bookletter BL-057; and (2) providing electronic transaction, fixed asset, trustee or other similar services that are integral to the daily internal operations of System institutions.

We are proposing this limitation for a number of reasons. First, the Agency does not want to set in motion a proliferation of System-controlled UBEs organized for numerous purposes by a single System institution. Such a proliferation could create a costly administrative burden for the Agency and complicate FCA's oversight authority. Moreover, the creation of one-member UBEs does not foster System collaborative efforts aimed at providing more efficient System operations and improved services to agriculture, agricultural producers, and rural America. Just as Congress encouraged System collaboration through the creation of the 4.25 service corporations, the use of UBEs would, generally, be reasonable and supportable from a business perspective when undertaken through System institution partnerships or multi-member limited liability companies. Finally, without reasonable and supportable reasons to form a UBE, including a one-member UBE, System institutions should conduct all aspects of their business activity either directly or through a service corporation under section 4.25 of the Act.

Regardless of the limitations on one-member UBEs, we recognize that the use of a UBE to perform services integral to a System institution's daily internal operations, as noted above, may lessen administrative burdens and reduce costs for a System institution. FCA may determine that some of these integral and internal services that a UBE, including a one-member UBE, could provide would become eligible for the notice provision in proposed § 611.1154. If so, we would inform System institutions of this development through an FCA Bookletter or other similar means.

We note that, under the agricultural credit association (ACA) structure, the ACA and its subsidiary production credit association (PCA) and Federal land credit association (FLCA) are treated by FCA as one entity for most regulatory purposes. Also, we note that an Agricultural Credit Bank (ACB) and its Farm Credit Bank (FCB) subsidiary are treated by FCA as a single entity for most regulatory purposes. Therefore, we would consider any UBE formed solely between an ACA and its subsidiary PCA and FLCA or an ACB and its subsidiary FCB as a one-member UBE (and not a multi-member UBE) that could be organized only for the limited purposes set forth above.

A fifth restriction would limit a UBE organized as a partnership to one that is established between or among two or more System institutions that do not have a common board of directors. An ACA and its PCA and FLCA subsidiaries, which operate under a common board of directors, are treated by FCA as one entity for most regulatory purposes, and could not create a partnership between or among themselves under this rule. Similarly, an ACB and its FCB subsidiary, also treated by FCA as one entity for most regulatory purposes, could not create a partnership between themselves.

A sixth restriction would prohibit one or more System institutions that organize or invest in a UBE from creating a subsidiary of the UBE, or enabling the UBE to create its own subsidiary or any other type of affiliated entity. This restriction is essential given FCA's obligations as an independent, safety and soundness regulator of a GSE. The complex arrangements that could possibly be established between System-owned or controlled UBEs and other special purpose vehicles currently permitted under various State laws could, as stated above, create a costly administrative burden for the Agency and complicate FCA's regulatory, examination, and enforcement oversight of the System's safety and soundness. For this reason, we are prohibiting System institutions from propagating additional subsidiaries or any other affiliated entities through their UBEs.

A seventh restriction requires that a System institution's liability be limited to the amount of the institution's equity investment in the UBE, thus preserving a significant benefit for the use of such a business structure — the concept of limited liability. Therefore, System institutions could not serve as a general partner in those UBEs organized as limited partnerships.

An eighth restriction would limit the aggregate amount of equity investments that a System institution is authorized to hold in all UBEs to one percent of the institution's total outstanding loans calculated at the time of each investment. The proposed rule allows FCA to approve an exception to this limitation on a case-by-case basis. In addition, FCA may impose a limitation that is lower than the one-percent aggregate limit based on safety or soundness and other relevant concerns. We believe this limit to be reasonable given that such an investment imposes a financial liability on a System institution up to the amount of its total investments in UBEs. Such an investment remains at-risk; it is recovered only after the System institution sells its interest to other investors or the UBE owners receive some of the proceeds from the liquidated assets of the UBE (if any such proceeds remain after satisfying all other obligations of the UBE). To calculate the investment limit under proposed § 611.1153(h), the rule would require that equity investments held by a service corporation be attributed to its System institution bank and association owners based on their percentage of ownership of the service corporation. This limit would not apply to equity investments made in one-member UBEs organized to acquire and manage unusual or complex collateral associated with loans.

The ninth restriction prohibits a System institution from making any equity investment in a third-party UBE except as may be authorized by FCA on a case-by-case basis under § 615.5140(e) for de minimis and passive investment purposes (such requests would be considered outside of this rule). Also, a System institution is prohibited from being named as the general partner, manager or primary beneficiary of a third-party UBE. Such arrangements have the potential to subject a System institution to liability and reputational risks created by the third-party UBE and to result in actual or apparent conflicts of interest that neither a System institution nor FCA could adequately control. Finally, such arrangements could dilute the Agency's oversight of System activities and diminish FCA's ability to ensure the safety and soundness of the System.

A final restriction would prohibit non-System entities or persons from holding any equity interest in a System-controlled UBE with one exception. Non-System entities or persons would be able to hold up to 20 percent of the equity of a System-controlled UBE that is organized to provide services integral to the daily internal operations of a System institution. This percentage of non-System ownership is the same non-System ownership percentage that FCA regulations currently permit for service corporations organized by one or more System institutions under section 4.25 of the Act. The ninth and final restrictions do not apply to UBEs formed for the purpose of acquiring and managing unusual or complex collateral associated with multiple-lender loan transactions in which non-System persons or entities are participants.

5. Notice-Only Requirement for Certain UBE Equity Investments [§ 611.1154]

In proposed § 611.1154, we describe the specific types of UBEs that a System institution may organize or invest in by providing sufficient advance notice to the FCA. This section also sets forth the specific information that a System institution must include in its notice as well as where the notice must be filed.

This "notice-only" provision would be limited to the following UBEs:

a. Those engaged in acquiring and managing the unusual or complex collateral associated with loans as described in FCA Bookletter BL-057, dated April 2, 2009; and

b. Those providing hail or multi-peril crop insurance services in accordance with § 618.8040.

FCA may determine that other UBE business activity is also appropriate for this "notice-only" provision and, in such an event, would notify all System institutions by bookletter or other means. Only System institutions with a composite FIRS rating of 1 or 2 would qualify for the "notice-only" provision. All other System institutions that intend to form or invest in a UBE must obtain FCA's prior approval under the provisions in § 611.1155 regardless of the nature or purpose of the intended UBE.

A System institution that qualifies for the "notice-only" provision would be required to submit articles of formation as defined in § 611.1151 that address basic information on the UBE's ownership, control, and operations. The System institution would also need to specify the dollar amount of its investment in the UBE and provide a certified resolution from its board of directors that the board has authorized the UBE investment and business activity and has given its approval to submit the notice to FCA. A letter from the funding bank that the bank has approved such investment would also be required. For those System institutions forming a UBE for hail or multi-purpose crop insurance services, or for other UBE activity that FCA determines appropriate for the "notice-only" provision, the notice would need to include a statement from the board of directors explaining the operating efficiencies and benefits to be gained from the conduct of business through a UBE. The statement must also affirm that the UBE is necessary or expedient to the institution's business; that it will operate with transparency; that it will operate in a manner that prevents conflicts of interest between the UBE and the institution itself; that the UBE will comply with all applicable Federal, State, and local laws; and that the UBE will not be used by the System institution to make direct loans, perform any functions, or provide any services that the System institution is not authorized to provide under the Act and FCA regulations or that go beyond the stated purpose of the UBE. FCA may require additional information under the notice provision or allow the omission of some information. Finally, System institutions that organize or invest in UBEs under this "notice-only" provision must comply with the ongoing requirements and disclosure and reporting requirements of §§ 611.1156 and 611.1157, respectively.

6. <u>Approval Process</u> [new § 611.1155]

In § 611.1155, we describe the documents that FCA would require to review a request for approval to organize or invest in a UBE if the request would not qualify for the "notice-only" provision in § 611.1154. We would ask a System institution to explain the risk characteristics of the investment, the initial amount of equity it plans to invest in the UBE, the purpose of the UBE, and its objectives. A System institution must provide support for its need to establish or invest in a UBE. We would also ask for a statement on the operating efficiencies that the System institutions expect to achieve and the benefits they expect to derive from using the UBE. A System institution would be required to submit the articles of formation defined in § 611.1151 that address basic information on the UBE's ownership, management structure, and operations. We would also require a certified resolution of the institution's board of directors approving the equity investment in the UBE and the UBE's business activity as well as a letter from the funding bank that it has approved the institution's investment in the UBE. In addition, we would require that an institution's board of directors provide us with a statement that the UBE is necessary or expedient to the institution's business; that it will operate with transparency; that it will operate in a manner that prevents conflicts of interest between the UBE and the institution itself; that the UBE will comply with all applicable Federal, State, and local laws; and that the UBE will not be used by the System institution to make direct loans, perform any functions, or provide any services that the System institution is not authorized to provide under the Act and FCA regulations or that go beyond the stated purpose of the UBE. The institutions may also submit any other information they deem necessary. FCA may require additional information or allow the omission of some information depending on the complexity of the UBE request. If FCA denies approval of the request, we will specify in writing our reasons for denial.

7. <u>Ongoing Requirements</u> [new § 611.1156]

Any System institution that organizes or invests in a UBE for the delivery of services or functions under the provisions of this rule would be expected to maintain and ensure FCA's access to all documents and records of the UBE. Also, a System institution would need to be prepared to divest its ownership interest or withdraw as a member or partner from any UBE that conducts activities beyond its approved limited purpose or that are contrary to the Act or FCA regulations. Under the proposed rule, if the FCA directed the System institution to divest its equity investment in, or withdraw as a member, partner, general partner, managing member or primary beneficiary of, a System-owned and controlled UBE, the institution would be required to do so as soon as practicable.

If a System institution fails to divest its equity investment in, or withdraw as a member, partner, general partner, managing member or primary beneficiary of, a System-owned and controlled UBE, as directed by the FCA within a reasonable period of time, such institution may be subject to an enforcement action pursuant to FCA's enforcement authority under part C of title V of the Act.

8. Disclosure and Reporting Requirements [§ 611.1157]

All System institutions that hold equity investments in UBEs would be required to include information about their equity investments and business activities in their annual reports to shareholders. We propose amending § 620.5, which prescribes the content of the annual report to shareholders, to include this requirement. FCA could also direct that System institutions holding equity investments in UBEs make periodic reports to FCA as required by § 621.12.

System institutions with UBEs that are grandfathered under the rule through the provision in § 611.1158 (discussed below) would be subject to the ongoing requirements of § 611.1156 and all disclosure and reporting requirements of § 611.1157.

We also propose that a System institution dissolving a UBE that it controls be required to provide a timely report to FCA when the dissolution occurs. This reporting will enable FCA to have current information on the status of UBE activity.

9. Grandfather Provision [new § 611.1158]

We propose grandfathering from the Notice and Approval provisions of the rule a System institution's organization of, or investment in, a UBE that received specific, written approval by FCA prior to the date this proposed rule would become effective as a final rule. We would also grandfather those UBEs organized pursuant to the guidance in FCA Bookletter BL-057. All System institutions grandfathered would remain subject to the conditions of approval imposed at the time of FCA's approval and be subject to the ongoing requirements of § 611.1156 and the disclosure and reporting requirements of § 611.1157. System institutions so grandfathered could not change or expand the UBE business activity, ownership interests in, or control of the UBE without providing notice to FCA at least 20 business days in advance of any change. If FCA determined that the proposed change or expansion is material, it could require the System institutions to submit a new approval request under § 611.1155.

B. Other Miscellaneous Changes

We propose conforming changes to various FCA regulatory sections to delete terms made obsolete by a final UBE rule and to add new regulatory sections cross-referenced in this proposed regulation.

Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FCA hereby certifies that the proposed rule would not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, Farm Credit System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

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[1]Sections 1.5(15) and 3.1(13)(A) of the Act set forth the investment authorities for System banks. Sections 2.2(10) and 2.12(18) of the Act set forth the investment authorities for System associations. FCA regulations in subpart E of part 615 imbue service corporations, chartered under section 4.25 of the Act, with the same investment authorities as their organizing System banks and associations.

[2]Sections 1.5(3), (15) and (21); 2.2(3), (10) and (20); 2.12(3), (18) and (19); 3.1(3) and (16) of the Act.

[3]Section 4.25 and 4.28(A), added to the Act in 1980, expressly authorize System banks and associations to organize service corporations. Congress stated that this authority was needed to provide a more efficient way for System banks to coordinate services. Service corporations, like System banks and associations, are federally chartered instrumentalities and subject to the same FCA supervisory, regulatory and enforcement oversight as System banks and associations. Service corporations are authorized to provide the same functions and services as banks and associations with two significant exceptions: they cannot extend credit or provide insurance services.

[4]Section 4.19 of the Act.

[5]This perspective is noted in the FCA Board’s Policy Statement (FCA-PS-80) on Cooperative Operating Philosophy—Serving the Members of Farm Credit System Institutions, dated October 14, 2010, and published in the Federal Register at 75 FR 64728 on October 20, 2010.

[6]FCA Bookletter BL-057 on "Use of State-Chartered Business Entities to Hold Acquired Property," dated April 2, 2009, provides guidance on the System’s use of UBEs to acquire and manage unusual or complex collateral associated with loans.

[7]Pub. L. 107-171, title VI, sec. 6029 (2002), as amended by the Food, Conservation, and Energy Act of 2008, Pub. L. 110-246, title VI, sec. 6027, and USDA regulations at 7 CFR 4290.10 through 4290.3099. FCA has the authority to ensure that a System institution’s investment in a RBIC is safe and sound and that they operate the RBIC in accordance with law and regulation.

[8]The term control as it is used in the context of this proposed rule is based on the guidance provided in Generally Accepted Accounting Principles (GAAP) under the Financial Accounting Standards Board’s Accounting Standards Codification (ASC). See primary discussion of control at ASC 810-10-15 and ASC 810-10-25; significant influence over an investment at ASC 323-10-15; and control for limited partnerships and similar entities, including LLCs, etc. at ASC 810-20-25. See also proposed Accounting Standards Update 2011-220 for possible revisions to these sections.

[9]The rule would allow a System institution to serve as a general partner of an LLLP, but not an LP, since the liability for the partnership’s debts and obligations is limited to the amount invested by the general partner in an LLLP but not in an LP. We note that an LLP does not have a general partner because all partners in an LLP have limited liability.

List of Subjects

12 CFR Part 604

Sunshine Act.

12 CFR Part 611

Agriculture, Banks, banking, Rural areas.

12 CFR Part 612

Agriculture, Banks, banking, Conflict of interests, Crime, Investigations, Rural areas.

12 CFR Part 619

Agriculture, Banks, banking, Rural areas.

12 CFR Part 620

Accounting, Agriculture, Banks, banking, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 621

Accounting, Agriculture, Banks, banking, Penalties, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 622

Administrative practice and procedure, Crime, Investigations, Penalties.

12 CFR Part 623

Administrative practice and procedure.

12 CFR Part 630

Accounting, Agriculture, Banks, banking, Organization and functions (Government agencies), Reporting and recordkeeping requirements, Rural areas.

For the reasons stated in the preamble, parts 604, 611, 612, 619, 620, 621, 622, 623, and 630 of chapter VI, title 12 of the Code of Federal Regulations are proposed to be amended as follows:

PART 604--FARM CREDIT ADMINISTRATION BOARD MEETINGS

1. The authority citation for part 604 continues to read as follows:

Authority: Secs. 5.9, 5.17 of the Farm Credit Act (12 U.S.C. 2243, 2252).

§ 604.420 [Amended]

2. Section 604.420 is amended by removing the words "service organizations" in paragraph (i)(1) and adding in their place, the words "service corporations chartered under the Act."

PART 611--ORGANIZATION

3. The authority citation for part 611 is revised to read as follows:

Authority: Secs. 1.2, 1.3, 1.4, 1.5, 1.12, 1.13, 2.0, 2.1, 2.2, 2.10, 2.11, 2.12, 3.0, 3.1, 3.2, 3.3, 3.7, 3.8, 3.9, 3.21, 4.3A, 4.12, 4.12A, 4.15, 4.20, 4.21, 4.25, 4.26, 4.27, 4.28A, 5.9, 5.17, 5.25, 7.0-7.13, 8.5(e) of the Farm Credit Act (12 U.S.C. 2002, 2011, 2012, 2013, 2020, 2021, 2071, 2072, 2073, 2091, 2092, 2093, 2121, 2122, 2123, 2124, 2128, 2129, 2130, 2142, 2154a, 2183, 2184, 2203, 2208, 2209, 2211, 2212, 2213, 2214, 2243, 2252, 2261, 2279a-2279f-1, 2279aa-5(e)); secs. 411 and 412 of Pub. L. 100-233, 101 Stat. 1568, 1638; sec. 414 of Pub. L. 100-399, 102 Stat. 989, 1004.

§ 611.1130 [Amended]

4. Section 611.1130 is amended in the first sentence of paragraph (a) by removing the words "service organizations organized under the Act" and adding in their place, the words "service corporations chartered under the Act".

5. Amend Part 611 by revising the heading of subpart I to read as follows:

Subpart I--Service Corporations

§ 611.1136 [Amended]

6. Section 611.1136 is amended by:
a. Revising the heading of § 611.1136;
b. Removing the words "and unincorporated service organizations" in paragraph (c); and
c. Removing the words "service organizations" each place they appear and adding in their place, the words "service corporations".
The revision reads as follows:

§ 611.1136 Regulation and examination of service corporations.

7. Part 611 is amended by adding a new subpart J, consisting of §§ 611.1150 through 611.1158, to read as follows:

Subpart J--Unincorporated Business Entities

Sec.

§ 611.1150 Purpose and scope.

(a) *Purpose*. This subpart sets forth the parameters for one or more Farm Credit System (System) institutions to organize or invest in an Unincorporated Business Entity (UBE) in accordance with the Farm Credit Act of 1971, as amended (Act).

(b) *Scope*. Except as authorized under these regulations, no System institution may manage, control, become a member or partner, or invest in a State-organized or chartered business entity. This rule applies to each System institution that organizes or invests in a UBE, including a UBE organized for the express purpose of investing in a Rural Business Investment Company. This rule does not apply to UBEs that one or more System institutions have the authority to establish as Rural Business Investment Companies pursuant to the provisions of title VI of the Farm Security and Rural Investment Act of 2002, as amended (FSRIA) and United States Department of Agriculture regulations implementing FSRIA.

§ 611.1151 Definitions.

For purposes of this subpart, the following definitions apply:

Articles of formation means registration certificates, charters, articles of organization, partnership agreements, membership or trust agreements, operating, administration or management agreements, fee agreements or any other documentation on the establishment, ownership, or operation of a UBE.

Control means that one System institution, directly or indirectly, owns more than 50 percent of the UBE's equity or serves as the general partner of an LLLP, or constitutes the sole manager or the managing member of a UBE. However, under generally accepted accounting principles (GAAP), the power to control may also exist with a lesser percentage of ownership, for example, if a System institution is the UBE's primary beneficiary, exercises significant influence over the UBE or establishes control under other facts and circumstances in accordance with GAAP. Under this definition, a System institution also will be deemed to have control over the UBE if it exercises decision-making authority in a principal capacity of the UBE as defined under GAAP.

Equity investment means a System institution's contribution of money or assets to the operating capital of a UBE that provides ownership rights in return.

System institution means each System bank under titles I or III of the Act, each System association under title II of the Act, and each service corporation chartered under section 4.25 of the Act.

Third-party UBE means a UBE that is owned or controlled by one or more non-System persons or entities as the term "control" is defined under GAAP.

UBE means a Limited Partnership (LP), Limited Liability Partnership (LLP), Limited Liability Limited Partnership (LLLP), Limited Liability Company (LLC), Business or other Trust Entity (TE), or other business entity established and maintained under State law that is not incorporated under any law or chartered under Federal law.

UBE business activity means the services and functions delivered by a UBE for one or more System institutions.

§ 611.1152 Authority over equity investments in UBEs for business activity.

(a) *Regulation, supervisory, oversight, examination and enforcement authority*. FCA has regulatory, supervisory, oversight, examination and enforcement authority over each System institution's equity investment in or control of a UBE and the services and functions that a UBE performs for the System institution. This includes FCA's authority to require a System institution's dissolution of, disassociation from, or divestiture of an equity investment in a UBE, or to otherwise condition the approval of equity investments in UBEs.

(b) *Assessing UBE investments and business activity*. In accordance with section 5.15 of the Act and § 607.2(h), the cost of regulating and examining equity investments in UBEs and the services and functions that UBEs can perform for System institutions will be taken into account when assessing a System institution for the cost of administering the Act.

§ 611.1153 General restrictions and prohibitions on the use of UBEs.

(a) *Authorized UBE business activity*. All UBE business activity must be:

(1) Necessary or expedient, as determined by the FCA, to the business of one or more System institutions owning the UBE; and

(2) In no instance greater than the functions and services that one or more System institutions owning the UBE are authorized to perform under the Act and as determined by the FCA.

(b) *Circumvention of cooperative principles*. System institutions are prohibited from using UBEs to engage in direct lending activities or any other activity that would circumvent the application of cooperative principles as determined by FCA, including borrower rights as described in section 4.14A of the Act, or stock ownership, voting rights or patronage as described in section 4.3A of the Act.

(c) *Transparency and the avoidance of conflicts of interest*. Each System institution must ensure that:

(1) The UBE is held out to the public as a separate or subsidiary entity;

(2) The business transactions, accounts, and records of the UBE are not commingled with those of the System institution; and

(3) All transactions between the UBE and System institution directors, officers, employees, and agents are conducted at arm's length, in the interest of the System institution, and in compliance with standards of conduct rules in §§ 612.2130 through 612.2270.

(d) *Limit on one-member UBEs*. A UBE owned solely by a single System institution (including between and among a parent agricultural credit association and its production credit association and Federal land credit association subsidiaries and between a parent agricultural credit bank and its subsidiary Farm Credit Bank) as a one-member UBE is limited to the following special purposes:

(1) Acquiring and managing the unusual or complex collateral associated with loans; and

(2) Providing limited services such as electronic transaction, fixed asset, trustee or other services that are integral to the daily internal operations of a System institution.

(e) *Limit on UBE partnerships*. A System institution operating through a parent-subsidiary structure may not create a UBE partnership between or among the parent agricultural credit association and its production credit association and Federal land credit association subsidiaries or between a parent Agricultural Credit Bank and its Farm Credit Bank subsidiary.

(f) *Prohibition on UBE subsidiaries*. A System institution is prohibited from creating a subsidiary of a UBE that it has organized or invested in under this subpart or from enabling the UBE itself to create a subsidiary or any other type of affiliated entity.

(g) *Limit on potential liability*.

(1) Each System institution's equity investment in a UBE must be established in a manner that will limit potential exposure of the System institution to no more than the amount of its investment in the UBE.

(2) A System institution cannot become a general partner of any partnership other than an LLLP.

(h) *Limit on amount of equity investment in UBEs*. The aggregate amount of equity investments that a single System institution is authorized to hold in UBEs must not exceed one percent of the institution's total outstanding loans, calculated at the time of each investment. On a case-by-case basis, FCA may approve an exception to this limitation that would exceed the one-percent aggregate limit. Conversely, FCA may impose a percentage limit lower than the one-percent aggregate limit based on safety or soundness and other relevant concerns. This one-percent aggregate limit does not apply to equity investments in one-member UBEs as permitted in paragraph (d)(1) of this section. Any equity investment made in a UBE by a service corporation must be attributed to its System institution owners based on the ownership percentage of each bank or association.

(i) *Prohibition on relationship with a third-party UBE*. A System institution is prohibited from:

(1) Making any equity investment in a third-party UBE except as may be authorized on a case-by-case basis under § 615.5140(e) for de minimis and passive investments. Such requests would be considered outside of this rule.

(2) Serving as the general partner or manager of a third-party UBE; or

(3) Being designated as the primary beneficiary of a third-party UBE, either alone or with other System institutions.

(j) *Limitation on non-System equity investments*.

Non-System persons or entities may not invest in a UBE that is controlled by a System institution except that non-System persons or entities may own 20 percent or less of the equity of a System-controlled UBE organized to deliver services integral to the daily internal operations of a System institution.

(k) *UBEs formed for acquiring and managing collateral*. The provisions of paragraphs (i) and (j) in this section do not apply to UBEs formed for the purpose of acquiring and managing unusual or complex collateral associated with multiple-lender loan transactions in which non-System persons or entities are participants.

§ 611.1154 Notice of equity investments in UBEs.

(a) *Applicability*. This notice provision is applicable only to System institutions that have a composite Financial Institution Rating System (FIRS) rating of 1 or 2 and wish to make an equity investment in UBEs whose activities are limited to the following purposes:

(1) Acquiring and managing unusual or complex collateral associated with loans;

(2) Providing hail or multi-peril crop insurance services in collaboration with another System institution in accordance with § 618.8040; and

(3) Any other UBE business activity that FCA determines to be appropriate for this "notice-only" provision.

(b) *Notice requirements*. A System institution must provide reasonable written notice to FCA. System institutions are encouraged to submit such notice as soon as possible, but it must be submitted no later than 20 business days in advance of making an equity investment in a UBE for authorized UBE business activity described in paragraph (a) of this section. The notice must include:

(1) The UBE's articles of formation, including its name and the State in which it is organized, length of time it will exist, its partners or members, and its management structure;

(2) The dollar amount of the System institution's equity investment in the UBE;

(3) A certified resolution of the System institution's board of directors authorizing the equity investment in, and business activity of, the UBE and the board's approval to submit the notice to the FCA;

(4) A letter from the funding bank that it has approved the institution's equity investment in the UBE;

(5) For those UBEs identified in paragraphs (a)(2) and (3) of this section, a detailed statement from the System institution's board of directors that the UBE:

(i) Is needed to achieve operating efficiencies and benefits;

(ii) Is necessary or expedient to the System institution's business;

(iii) Will operate with transparency;

(iv) Will conduct its business activity in a manner designed to prevent conflicts of interest between its purpose and operations and the mission and operations of the System institution(s);

(v) Will otherwise be in compliance with applicable Federal, State, and local laws; and

(vi) Will not be used by the System institution to make direct loans; perform any functions or provide any services that the System institution is not authorized to perform or provide under the Act and FCA regulations; or to exceed the stated purpose of the UBE as set forth in its articles of formation.

(6) Any additional information the System institution wishes to submit.

(c) *Supplementation or omission of information*. FCA may require the supplementation or allow the omission of any information required under paragraph (b) of this section.

(d) *Other requirements*. All System institutions under this "notice-only" provision must also comply with the ongoing requirements and disclosure and reporting requirements set forth in §§ 611.1156 and 611.1157, respectively, of this subpart.

§ 611.1155 Approval of equity investments in UBEs.

(a) *Request*. System institutions must receive FCA approval before organizing or investing in any UBE that does not qualify for the "notice-only" provision set forth in § 611.1154 of this subpart.

A request for approval under this section must include the following information:

(1) A detailed statement of the risk characteristics of the investment, as required by § 615.5140(e) and the initial amount of equity investment;

(2) A detailed statement on the purpose and objectives of the UBE; the need for the UBE and the operating efficiencies and benefits that will be achieved by using the UBE;

(3) The proposed articles of formation addressing, at a minimum, the following:

(i) The UBE's name, the State in which it is organized, the city and State in which its principal office is to be located, and its partners or members; and management structure;

(ii) Specific business activities that the UBE will conduct;

(iii) General powers of the UBE;

(iv) Ownership, voting, partnership, membership and operating agreements for the UBE;

(v) Procedures to adopt and amend the partnership, membership or operating agreement of the UBE;

(vi) The standards and procedures for the application and distribution of the UBE's earnings; and

(vii) Length of time the UBE will exist.

(4) A certified resolution of the System institution's board of directors authorizing the equity investment in the UBE and the UBE business activity and the board's approval to submit the request to the FCA.

(5) A letter from the funding bank that it has approved the institution's equity investment in the UBE;

(6) A statement from the System institution's board of directors that the UBE:

(i) Is necessary or expedient to the System institution's business;

(ii) Will operate with transparency;

(iii) Will conduct its business activity in a manner designed to prevent conflicts of interest between its purpose and operations and the mission and operations of the System institution(s);

(iv) Will comply with applicable Federal, State, and local laws; and

(v) Will not be used by the System institution to make direct loans; perform any functions or provide any services that the System institution is not authorized to perform or provide under the Act and FCA regulations; or exceed the purpose of the UBE as stated in its articles of formation.

(7) Any additional information the System institution wishes to submit or any other supporting documentation that FCA may request.

(b) *Supplementation or omission of information*. FCA may require the supplementation or allow the omission of any information required under paragraph (a) of this section based on the complex or noncomplex nature of the proposed UBE.

(c) *Denial of a request*. The FCA will specify in writing to the submitting System institutions the reasons for denial of any request to organize or invest in a UBE.

§ 611.1156 Ongoing requirements.

A System institution that makes an equity investment in a UBE under §§ 611.1154 or 611.1155 of this subpart must also comply with the following requirements:

(a) Maintain and ensure FCA's access to all books, papers, records, agreements, reports and other documents of each UBE necessary to document and protect the institution's interest in each entity;

(b) Divest, as soon as practicable, the institution's equity or beneficial interest in (or withdraw membership from) any UBE that conducts activities beyond those authorized to carry out its limited purpose or that are contrary to the Act or FCA regulations; and

(c) Divest the institution's respective ownership or managerial duties in the UBE as soon as practicable, if directed to do so by FCA.

(d) Divest the institution's ownership interest or withdraw as a member or partner from any UBE as soon as practicable if, after a System institution organizes or invests in a System-controlled UBE, non-System persons or entities obtain control as defined under GAAP. Alternatively, as soon as practicable, the non-System persons or entities must relinquish control as defined under GAAP. This paragraph does not apply to UBEs formed for the purpose of acquiring and managing unusual or complex collateral associated with multiple-lender loan transactions in which non-System persons or entities are participants.

§ 611.1157 Disclosure and reporting requirements.

(a) *Annual report to shareholders*. In its annual report to shareholders, as set forth in § 620.5(a)(12), a System institution must provide information on its UBE investment and business activity.

(b) *Periodic reports as directed*. As directed by FCA, a System institution may be required to submit periodic reports to FCA on any equity investment in a UBE or UBE status as provided under § 621.12, and in accordance with §§ 621.13 and 621.14.

(c) *Dissolution of a UBE*. A System institution must submit a timely report to FCA on the dissolution of a UBE that it controls.

§ 611.1158 Grandfather provision.

(a) *Scope*. The following equity investments in UBEs are grandfathered from the Notice and Approval provisions under §§ 611.1154 and 611.1155, respectively, of this subpart.

(1) Those UBE formations or equity investments that received specific, written approval by FCA prior to the effective date of this regulation; and

(2) Those UBEs organized to acquire or manage unusual or complex collateral associated with loans.

(b) *System institutions' obligations*. All System institutions with grandfathered UBEs:

(1) Remain subject to their conditions of approval;

(2) Are subject to the ongoing requirements of § 611.1156 and the disclosure and reporting requirements of § 611.1157 of this subpart; and

(3) May not change or expand the UBE business activity, ownership interests in, or control of the UBE without providing notice of such changes to FCA at least 20 business days in advance of any change or expansion. If the proposed change or expansion is determined to be material, FCA may require the System institution(s) to submit an "Approval" request under § 611.1155 of this subpart.

PART 612--STANDARDS OF CONDUCT AND REFERRAL OF KNOWN OR SUSPECTED CRIMINAL VIOLATIONS

8. The authority citation for part 612 continues to read as follows:

Authority: Secs. 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2243, 2252, 2254).

9. Section 612.2130 is amended by revising paragraphs (p) and (t) to read as follows:

§ 612.2130 Definitions.

*** * * * ***

(p) *Service corporation* means each service corporation chartered under the Act.

*** * * * ***

(t) *System institution* and *institution* mean any bank, association, or service corporation in the Farm Credit System, including the Farm Credit Banks, banks for cooperatives, Agricultural Credit Banks, Federal land bank associations, agricultural credit associations, Federal land credit associations, production credit associations, the Federal Farm Credit Banks Funding Corporation, and service corporations chartered under the Act.

PART 619--DEFINITIONS

10. The authority citation for part 619 is revised to read as follows:

Authority: Secs. 1.4, 1.5, 1.7, 2.1, 2.2, 2.4, 2.11, 2.12, 3.1, 3.2, 3.21, 4.9, 5.9, 5.17, 5.19, 7.0, 7.1 , 7.6, 7.8, and 7.12 of the Farm Credit Act (12 U.S.C. 2012, 2013, 2015, 2072, 2073, 2075, 2092, 2093, 2122, 2123, 2142, 2160, 2243, 2252, 2254, 2279a, 2279a-1, 2279b, 2279c-1, 2279f); sec. 514 of Pub. L. 102-552, 106 Stat. 4102.

11. Part 619 is amended by adding a new § 619.9338 to read as follows:

§ 619.9338 Unincorporated business entities.

An *Unincorporated Business Entity* means a Limited Partnership (LP), Limited Liability Partnership (LLP), Limited Liability Limited Partnership (LLLP), Limited Liability Company (LLC), Business or other Trust Entity (TE), or other business entity established and maintained under State law that is not incorporated under any law or chartered under Federal law.

PART 620--DISCLOSURE TO SHAREHOLDERS

12. The authority citation for part 620 is revised to read as follows:

Authority: Secs. 4.3, 4.3A, 4.19, 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2154, 2154a,2207, 2243, 2252, 2254); sec. 424 of Pub. L. 100-233, 101 Stat. 1568, 1656; sec. 514 of Pub. L. 102-552, 106 Stat. 4102.

13. Section 620.5 is amended by:

a. Removing the words "service organization" in paragraph (a)(3) and adding in their place, the words "service corporation chartered under the Act"; and

b. Adding a new paragraph (a)(11) to read as follows:

§ 620.5 Contents of the annual report to shareholders.

*** * * * ***

(a) * * *

(11) For banks and associations, business relationships with unincorporated business entities (UBEs).

(i) Except as provided in § 620.5(a)(12)(ii) of this section, describe the business relationship with any UBE, as defined in § 611.1151, that was organized by the bank or association or in which the bank or association has an equity interest. Include in the description the name of the UBE, the type of business entity, the purpose for which the UBE was organized, the scope of its activities, and the level of ownership. If the bank or association does not have an equity interest, but manages the operations of a UBE that is controlled by a System institution, describe this business relationship and any fees received.

(ii) If the UBE is a one-member UBE as described in § 611.1153(d)(1), the bank or association need only disclose the name of the UBE, the type of business entity, and the purpose for which the UBE was organized.

*** * * * ***

PART 621--ACCOUNTING AND REPORTING REQUIREMENTS

14. The authority citation for part 621 continues to read as follows:

Authority: Secs. 5.17, 8.11 of the Farm Credit Act (12 U.S.C. 2252, 2279aa-11); sec. 514 of

Pub. L. 102-552.

§ 621.1 [Amended]

15. Section 621.1 is amended by removing the words "service organizations" and adding in their place, the words "service corporations".

§ 621.2 [Amended]

16. In § 621.2 paragraph (e) is amended by removing the words "service organization" and adding in their place, the words "service corporation."

PART 622—RULES OF PRACTICE AND PROCEDURE

17. The authority citation for part 622 continues to read as follows:

Authority: Secs. 5.9, 5.10, 5.17, 5.25-5.37 of the Farm Credit Act (12 U.S.C. 2243, 2244, 2252, 2261-2273); 28 U.S.C. 2461 note; and 42 U.S.C. 4012a(f).

§ 622.2 [Amended]

18. In § 622.2 paragraph (d) is amended by removing the words "service organization chartered under part E of title IV of the Act" and adding in their place, the words "service corporation chartered under the Act."

PART 623—PRACTICE BEFORE THE FARM CREDIT ADMINISTRATION

19. The authority citation for part 623 is revised to read as follows:

Authority: Secs. 5.9, 5.10, 5.17, 5.25—5.37 of the Farm Credit Act (12 U.S.C. 2243, 2244, 2252, 2261-2273).

§ 623.2 [Amended]

20. In § 623.2 paragraph (d) is amended by removing the words "service organization chartered under part E of title IV of the Act" and adding in their place, the words "service corporation chartered under the Act."

PART 630—DISCLOSURE TO INVESTORS IN SYSTEM-WIDE AND CONSOLIDATED BANK DEBT OBLIGATIONS OF THE FARM CREDIT SYSTEM

21. The authority citation for part 630 is revised to read as follows:

Authority: Secs. 4.2, 4.9, 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2153, 2160, 2243, 2252, 2254); sec. 424 of Pub. L. 100-233, 101 Stat. 1568, 1656; sec. 514 of Pub. L. 102-552, 106 Stat. 4102.

§ 630.20 [Amended]

22. Section 630.20 is amended by removing the words "service organization" in paragraph (a)(2)

and adding in their place, the words "service corporation."

Date: September 6, 2012

Dale L. Aultman,
<u>Secretary,</u>
<u>Farm Credit Administration Board</u>.

77 FR 59050, 09/26/2012

Handbook Mailing HM-12-6

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 630

RIN 3052-AC77

Disclosure to Investors in System-wide and Consolidated Bank Debt Obligations of the Farm Credit System; System Audit Committee

AGENCY: Farm Credit Administration.

ACTION: Final rule.

SUMMARY: The Farm Credit Administration (FCA, us, we, or our) amends our regulations related to the Federal Farm Credit Banks Funding Corporation (Funding Corporation) System Audit Committee (SAC) and the Farm Credit System (System) annual report to investors. The final rule removes the provision for a two-thirds majority vote of the Funding Corporation board of directors to deny a request for resources by the SAC and requires the SAC to use resources to preserve and promote the safety and soundness of the System. The rule also requires quarterly reporting by the SAC to the Funding Corporation board and annual reporting to investors on resources used.

DATES: This regulation will be effective 30 days after publication in the Federal Register during which either or both Houses of Congress are in session. We will publish a notice of the effective date in the Federal Register.

FOR FURTHER INFORMATION CONTACT:

Deborah Wilson, Senior Accountant, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434,

or

Laura McFarland, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of this final rule are to:

- Allow the SAC unrestricted access to resources to engage legal counsel, consultants and outside advisors; and

- Clarify that the SAC must have the agreement of the Funding Corporation board of directors in order to appoint, compensate, and retain the external auditor of the combined System-wide reports.

II. Background

The Farm Credit Act of 1971, as amended (Act),[1] authorizes the FCA to issue regulations implementing the Act's provisions.[2] Our regulations are intended to ensure the safe and sound operations of System institutions and to govern the disclosure of financial information to shareholders of, and investors in, the System. Section 630.6(a) of our existing regulations requires the Funding Corporation to establish and maintain the SAC, including providing monetary and nonmonetary resources for SAC operations. Our existing regulation requires a two-thirds vote of the full Funding Corporation board to deny any SAC request for resources.

In a May 2010 petition, the SAC requested that we amend § 630.6(a) to allow the SAC the unfettered ability to engage outside advisors, consultants and legal counsel in the performance of its duties. In a February 14, 2012, proposed rulemaking, we proposed:

- Removing the requirement that the Funding Corporation Board deny a SAC request for resources by a two-thirds majority vote of the full board;
- The SAC use resources in a manner that would not adversely affect the safety and soundness of the System; and
- Disclosure of resources used by, and the composition of, the SAC.[3]

The 60-day comment period for the proposed rule closed on April 16, 2012.

III. Comments and Our Responses

We received comment letters on the proposed rule from each of the four Farm Credit banks, the Farm Credit Council (Council) on behalf of its membership, and a joint letter from the Funding Corporation and the SAC (joint letter). The Farm Credit banks and the Council expressed support for the comments made in the joint letter. We discuss the comments to our proposed rule and our responses below. Unless otherwise discussed in this preamble, those areas of the proposed rule not receiving comment are finalized as proposed.

A. System Audit Committee Authority [§ 630.6(a)]

All commenters supported removing the requirement that a two-thirds majority vote of the full Funding Corporation board of directors was needed to deny a SAC request for resources. Also, commenters supported the requirement that the SAC report at least quarterly to the Funding Corporation board on its use of resources.

Commenters expressed concern with the requirement that the SAC use Funding Corporation resources in a manner that would not adversely affect the safety and soundness of the System. They stated that the safety and soundness provision was not operational and could be subject to different interpretations. One commenter provided an example in which the SAC may choose not to investigate or uncover potential financial wrongdoing because disclosing how it used the resources and the results from the use of those resources may impact the System's cost of funds in a manner that could adversely affect the safety and soundness of the System. The commenter noted that failure of the SAC to investigate or uncover a potential financial wrongdoing could also adversely affect the safety and soundness of the System. We respectfully disagree with comments arguing that the provision may not be operational when there may be a duty to disclose financial wrongdoing which might adversely affect the cost of funds for the System. Uncovering financial wrongdoing and any unavoidable impact would not be contrary to the rule. While the wrongdoing itself may affect safety and soundness, the corrective actions taken to respond to and resolve the wrongdoing would be a positive impact on the safety and soundness of the System and, therefore, not prohibited under the rule. It is the financial wrongdoing that could adversely affect the safety and soundness of the System, not the action taken by the SAC to uncover and correct it.

Commenters stated that requiring the SAC to use Funding Corporation resources in a manner that would not adversely affect the safety and soundness of the System provision would create a standard that is stricter than that applied under governance best practices and should not be required. Some commenters expressed that holding the SAC to a stricter standard in the use of resources may hinder the Funding Corporation's ability to attract and retain SAC members, which could potentially damage the safety and soundness of the System. As the safety and soundness regulator of System institutions, including the Funding Corporation and its SAC, we expect all institutions to use resources according to law and regulations and in a safe and sound manner. We believe using resources accordingly and in such a manner should always be considered a best practice. Further, since the SAC is not composed solely of members of the board of directors as are other System institution audit committees,[4] we want to be clear that the SAC is held to the same safety and soundness standard.

Commenters stated the SAC cannot guarantee that the use of resources would lead directly to results that ensure the safety and soundness of the System. One commenter noted that the requirement may discourage the SAC from engaging outside third parties to assist with investigations or prevent the SAC from seeking their advice. The rule does not require the SAC use of resources guarantee the System's safety and soundness. Instead, the rule requires that the SAC not use Funding Corporation resources in a manner that would adversely affect the safety and soundness of the System or be contrary to law and regulation. We refer again to the example in which the SAC would use resources to uncover financial wrongdoing. The actual act of financial wrongdoing may adversely affect the safety and soundness of the System. The use of resources by the SAC to uncover and correct the wrongdoing may not be considered to have caused the adverse effect, but may help preserve and promote the safety and soundness of the System.

The joint letter asserted that the SAC is already bound by its fiduciary duties to act prudently. The joint letter stated that the Business Judgment Rule allows SAC members to rely on the advice of experts, but the safety and soundness provision would create a judicial and regulatory hindsight that the Business Judgment Rule was meant to deter. The commenter stated that this could potentially lead to a liability for SAC members.

The Business Judgment Rule provides a measure of liability protection to directors, officers, employees, and agents of a corporation when, in the course of decision-making, they place a reasonable reliance on expert advice. When applying the Business Judgment Rule, the courts consid-er whether the decision-making process involved careful consid-eration of reasonably available and relevant facts and whether the decision-maker honestly and reasonably believed that the decision was in the best interest of the institution. The safety and soundness of the System is in the best interest of the SAC and the Funding Corporation. We see nothing in the requirement to use Funding Corporation resources in a safe and sound manner that is contrary to the SAC's fiduciary duties or diminishes the protection offered the SAC under the "Business Judgment Rule." As such, the argument that the provision hinders or otherwise contradicts the principals behind the Business Judgment Rule is not meritorious.

The SAC's use of Funding Corporation resources must have the intended purpose of preserving or promoting the safety and soundness of the System. We do not believe that it is more difficult for the SAC to carry out its responsibilities in a manner that does not adversely affect the System's safety and soundness than it is for other System institution audit committees. However, in consideration of the comments, we are modifying the language to clarify the requirement. The provision as finalized places a positive duty on the SAC to use resources in a lawful manner and to preserve and promote the safety and soundness of the System. This provision does not prevent the Funding Corporation board from developing its own policies and procedures to address the request for and use of resources by the SAC.

B. <u>External Auditors</u> [§ 630.6(a)(4)(ii)(A)]

All commenters agreed with the proposed clarification that the SAC determines the appointment, compensation, and retention of the external auditor only with the agreement of the Funding Corporation board. However, commenters asked that the rule text make clear that this authority relates to the performance of the audit of the System-wide combined financial statements and not the audit fees related to the performance of the audit of the financial statements of individuals banks and associations. We do not believe any changes are needed to the language in § 630.6(a)(4)(ii). The rule clearly states that the appointment, compensation and retention of the external auditors relates solely to issuing the combined System-wide audit report and not the audit report of individual banks and associations. Our rule at § 620.30(d)(2) gives that authority to the audit committees of individual banks and associations. In addition, in a 2006 rulemaking, we made changes to our rules to limit the authority of the Funding Corporation, and by extension the SAC, to intervene in the activities of any bank or association's external auditor.[5]

The joint letter requested that the rule not require Funding Corporation board concurrence for ordinary or recurring external auditor fees. We do not believe this change is necessary because, as previously stated, the Funding Corporation board may develop its own procedures to address the activities of the SAC as long as those procedures do not conflict with law or regulation.

We finalize the provisions of § 630.6(a)(4)(ii)(A) as proposed.

C. <u>Disclosure of System Audit Committee Expenditures</u> [§ 630.20(n)]

We proposed in § 630.20(n) that Funding Corporation resources used by the SAC be disclosed by category and amount in the annual System-wide report to investors if the total of each expense category for the reporting year was $5,000 or more. The proposed categories included, at a minimum, administrative expenses, contracted legal services, contracted consultants and advisors, and other contracted services performed on behalf of the SAC. We proposed excluding from this section disclosure of the fees paid to the external auditor for issuing System-wide audit reports. That disclosure is required by existing § 630.20(k)(2).

Commenters expressed concern with the additional disclosures proposed in § 630.20(n). Other commenters contended that the disclosure placed a higher standard on the SAC than what is required of entities registered with the Securities Exchange Commission (SEC) or as required by the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).[6] The joint letter stated the disclosures were unnecessary and explained that as a best practice the SAC follows most SEC disclosure requirements, using a materiality assessment. Commenters suggested disclosures not be required before any investigation or similar inquiry by the SAC is completed. One commenter stated that the disclosures could reveal confidential information and might affect the ability of the SAC to engage outside consultants. The joint letter asserted attorney-client communications would also be compromised.

We believe disclosure of the use of Funding Corporation resources by the SAC provides transparency to System stockholders and investors and strengthens board and management accountability. Further, we believe removing the provision that a two-thirds majority vote of the full Funding Corporation board be required to deny an SAC request for resources necessitates an added level of accountability by the SAC.

We do not believe that disclosing the dollar amount of resources used to hire legal counsel, consultants and other categories of services would compromise confidentiality or attorney-client relations. The provision does not require the disclosure in the annual System-wide report to investors of the name of or service performed by legal counsel, advisors or outside consultants engaged by the SAC. Instead, the provision requires reporting the cost of and benefits to the System from the use of those resources. However, since disclosure of benefits derived from using those resources appears to be the source of commenters' concerns, and considering the safety and soundness constraints placed on the use of resources, we are finalizing the rule with the cost disclosure only and without the requirement to report the benefits of resources used. We expect the SAC to disclose information on the benefit from the use of resources to the Funding Corporation board.

One commenter requested that we limit the definition of external resources to "experts" engaged by the SAC and not include resources used by the SAC for off-site meeting facilities. The commenter stated that the use of these resources should instead be periodically reported to the Funding Corporation board. We respectfully disagree with the suggestion of limiting the disclosure on the SAC's use of resources to only "experts." The Funding Corporation is required to provide both monetary and nonmonetary resources to the SAC and we proposed disclosures of those resources to ensure that investors are provided transparent and complete disclosure on the use of resources by the SAC. Further, we identified categories of resources based on use, including a disclosure category of "administrative expenses," which may include either internal or external resources or both. Thus, if the SAC uses Funding Corporation resources for meeting sites, those expenses would be reported in the "administrative expense" category.

One commenter asserted that the $5,000 de minimis reporting threshold was too low and should be increased. We believe this threshold is reasonable given we are removing the requirement for a two-thirds majority vote of the full Funding Corporation board to deny an SAC request for resources. In addition, the threshold resembles other disclosure thresholds contained elsewhere in our rules. We are not increasing the reporting threshold in this final rule.

One commenter requested that we clarify the relationship of the proposed § 630.20(n) exemption from reporting external audit fees for issuance of System-wide audit reports with the existing requirement of § 630.20(k)(2), which requires the disclosure of fees. Existing § 630.20(k)(2) requires disclosure of fees paid to the external auditor during the reporting period for audit services, tax services, and non-audit services. Because § 630.20(k)(2) currently requires disclosure of these fees, we did not also propose requiring a similar disclosure requirement in § 630.20(n). We are revising the language in § 630.20(n) for clarity.

No comments were received on the proposed requirement to disclose in the annual System-wide report to investors the name, experience, and compensation of SAC members. Also, we received no comments on the categories of resources used by the SAC that were identified in the proposed rule and required to be disclosed. We finalize these provisions as proposed.

IV. <u>Regulatory Flexibility Act</u>

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FCA hereby certifies that this final rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, Farm Credit System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

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[1]Pub. L. 92-181, 85 Stat. 583 (1971), 12 U.S.C. 2001 et seq.

[2]12 U.S.C. 2252(a)(8), (9) and (10).

[3]77 FR 8179 (Feb. 14, 2012).

[4]The SAC is only required to have one-third of its membership from the Funding Corporation board of directors. Audit committee members of Farm Credit banks and associations are composed solely of members of the respective institution's board of directors.

[5]See 71 FR 76111, Dec. 20, 2006.

[6] Pub. L. 107-204, July 30, 2002. Congress enacted Sarbanes-Oxley after revelation of accounting and financial management scandals involving public companies. It was enacted to strengthen financial disclosure, reporting, and accountability requirements for publicly traded companies and other entities registered with the SEC. Farm Credit banks and associations are not subject to the governance requirements of Sarbanes-Oxley.

List of Subjects in 12 CFR Part 630

Accounting, Agriculture, Banks, banking, Organization and functions (Government agencies), Reporting and recordkeeping requirements, Rural areas.

For the reasons stated in the preamble, part 630 of chapter VI, title 12 of the Code of Federal Regulations is amended as follows:

PART 630—DISCLOSURE TO INVESTORS IN SYSTEM-WIDE AND CONSOLIDATED BANK DEBT OBLIGATIONS OF THE FARM CREDIT SYSTEM

1. The authority citation for part 630 is revised to read as follows:

Authority: Secs. 4.2, 4.9, 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2153, 2160, 2243, 2252, 2254); sec. 424 of Pub. L. 100-233, 101 Stat. 1568, 1656; sec. 514 of Pub. L. 102-552, 106 Stat. 4102.

2. Section 630.6 is amended by revising paragraphs (a)(3) and (a)(4)(ii)(A) to read as follows:

§ 630.6 Funding Corporation committees.

(a) * * *

(3) *Resources.* The Funding Corporation must provide the SAC monetary and nonmonetary resources the SAC determines necessary to enable it to perform the duties listed in paragraph (a)(4) of this section. The Funding Corporation must permit the SAC to contract, for reasons directly related to the duties listed in paragraph (a)(4) of this section, the services of external auditors, independent legal counsel, and outside advisors. The SAC must only use the resources of the Funding Corporation in a manner that complies with laws and regulations and for the purpose of preserving and promoting the safety and soundness of the System. The SAC must provide the Funding Corporation board of directors a quarterly accounting of expenditures made pursuant to this section.

(4) * * *

(ii) * * *

(A) Determine, with the agreement of the Funding Corporation board of directors, the appointment, compensation, and retention of the external auditors issuing System-wide audit reports;

* * * * *

3. Section 630.20 is amended by revising paragraph (n) to read as follows:

§ 630.20 Contents of the annual report to investors.

* * * * *

(n) *System Audit Committee.* The Funding Corporation must include in the System-wide Report to Investors a description of the System Audit Committee and its activities during the reporting period. At a minimum, the description must:

(1) List the names of the System Audit Committee members, including each member's term of office and principal occupation during the past 5 years. For each member, state the total cash and noncash compensation paid for services on the System Audit Committee during the reporting period.

(2) Disclose by category the monetary and nonmonetary resources used by the System Audit Committee during the reporting period. Discuss only those categories where the resources used within a category equaled or exceeded a total aggregate value of $5,000 during the reporting period. Fees paid for the audit of the System-wide financial statements, which are disclosed under paragraph (k)(2) of this section, are not included in any category under this paragraph. At a minimum, there must be separate categories for:

(i) Administrative expenses,

(ii) Contracted legal services,

(iii) Contracted consultants and advisors, and

(iv) Other contracted services, identifying the services.

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Date: September 20, 2012

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.