

**FARM CREDIT ADMINISTRATION****12 CFR Parts 607, 614, 615, and 620**

RIN 3052-AC09

**Assessment and Apportionment of Administrative Expenses; Loan Policies and Operations; Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Disclosure to Shareholders; Capital Adequacy Risk-Weighting Revisions**

AGENCY: Farm Credit Administration.

ACTION: Final rule.

**SUMMARY:** The Farm Credit Administration (FCA, we, our) issues this final rule changing our regulatory capital standards on recourse obligations, direct credit substitutes, residual interests, asset- and mortgage-backed securities, claims on securities firms, and certain residential loans. We are modifying our risk-based capital requirements to more closely match a Farm Credit System (FCS or System) institution's relative risk of loss on these credit exposures to its capital requirements. In doing so, our rule risk-weights recourse obligations, direct credit substitutes, residual interests, asset- and mortgage-backed securities, and claims on securities firms based on external credit ratings from nationally recognized statistical rating organizations (NRSROs). In addition, our rule will make our regulatory capital treatment more consistent with that of the other financial regulatory agencies for transactions and assets involving similar risk and address financial structures and transactions developed by the market since our last update. We also make a number of nonsubstantive changes to our regulations to make them easier to use.

**DATES:** *Effective Date:* 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:** Robert Donnelly, Senior Accountant, Office of Policy and Analysis, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4498; TTY (703) 883-4434; or Jennifer A. Cohn, Senior Attorney, 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 rule are to:

- Ensure FCS institutions maintain capital levels commensurate with their relative exposure to credit risk;
- Help achieve a more consistent regulatory capital treatment with the other financial regulatory agencies<sup>1</sup> for transactions involving similar risk; and
- Allow FCS institutions' capital to be used more efficiently in serving agriculture and rural America and supporting other System mission activities.

**II. Background***A. Rulemaking History*

The FCA published a proposed rule implementing a ratings-based approach for risk-weighting certain FCS assets on August 6, 2004.<sup>2</sup> The proposal incorporated an interim final rule the FCA published on March 28, 2003 that had implemented a ratings-based approach for investments in non-agency asset-backed securities (ABS) and mortgage-backed securities (MBS).<sup>3</sup> The proposal also incorporated a final rule the FCA published on May 26, 2004, that implemented a ratings-based approach for loans to other financing institutions (OFIs).<sup>4</sup>

We received 12 letters commenting on this proposal. Ten of these letters were from individual FCS institutions (including the Federal Agricultural Mortgage Corporation (Farmer Mac)) and one was from the Farm Credit Council, trade association for the System banks and associations. The final letter was from a commercial bank. All commenters generally applauded our overall effort to implement capital treatment that is more consistent with that of the other financial regulatory agencies but opposed one or more specific provisions of the proposed regulation. We discuss these comments, and our responses, later in this preamble.<sup>5</sup>

<sup>1</sup> We refer collectively to the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) as the "other financial regulatory agencies."

<sup>2</sup> 69 FR 47984.

<sup>3</sup> 68 FR 15045.

<sup>4</sup> 69 FR 29852.

<sup>5</sup> We also received a letter from CoBank. That letter did not comment on the proposed regulation. Rather, it suggested a coordinated System/FCA effort to jointly explore further implications and appropriateness of Basel II and volunteered CoBank as a testing bank for a possible "Quantitative Impact Study." We note that, separately from this regulation, FCA staff is currently evaluating the implementation of Basel II and will assess CoBank's suggestions as part of that evaluation.

*B. Basis of Risk-Based Capital Rules*

Since the late 1980s, the regulatory capital requirements applicable to federally regulated financial institutions, including FCS institutions, have been based, in part, on the risk-based capital framework developed by the Basel Committee on Banking Supervision (Basel Committee).<sup>6</sup> We first adopted risk-weighting categories for System assets as part of the 1988 regulatory capital revisions<sup>7</sup> required by the Agricultural Credit Act of 1987<sup>8</sup> and made minor revisions to these categories in 1998.<sup>9</sup> Risk-weighting is used to assign appropriate capital requirements to on- and off-balance sheet positions and to compute the risk-adjusted asset base for FCS banks' and associations' permanent capital, core surplus, and total surplus ratios. These previous risk-weighting categories were similar to those outlined in the Accord on International Convergence of Capital Measurement and Capital Standards (1988, as amended in 1998) (Basel Accord) and were also adopted by the other financial regulatory agencies. Our risk-based capital requirements are contained in subparts H and K of part 615 of our regulations.

*C. Subsequent Capital Developments*

Since the FCA adopted its previous risk-weighting regulations, much has occurred in the area of capital and credit risk. The Basel Committee has for a number of years been developing a new accord to reflect advances in risk management practices, technology, and banking markets. In June 2004, the Basel Committee released its document "International Convergence of Capital Measurement and Capital Standards: A Revised Framework." The Basel Committee intends for its new framework (known as Basel II) to be available for implementation as of year-end 2006, with the most advanced approaches to risk measurement available for implementation as of year-end 2007.<sup>10</sup>

In January 2005, the other financial regulatory agencies announced that they planned to publish a proposed rule and guidance implementing Basel II in mid-

<sup>6</sup> The Basel Committee is a committee reporting to the central banks and bank supervisors/regulators from the major industrialized countries that formulates standards and guidelines related to banking and recommends them for adoption by member countries and others. The Basel Committee has no formal supranational supervisory authority and its recommendations have no legal force.

<sup>7</sup> See 53 FR 39229 (October 6, 1988).

<sup>8</sup> Pub. L. 100-233 (January 6, 1988).

<sup>9</sup> See 63 FR 39219 (July 22, 1998).

<sup>10</sup> See the Basel Committee's Web site at <http://www.bis.org> for extensive information about Basel II.

year 2005 and that their final regulations would be effective in January 2008.<sup>11</sup> However, on April 29, 2005, these agencies announced that additional analysis was needed before they could publish a proposed rule.<sup>12</sup> The agencies emphasized that, although they are delaying their timeline, they remain committed to implementing Basel II.<sup>13</sup>

Basel II is very complex. In the United States, only a very small number of large, internationally active banking organizations will be subject to the entire, advanced Basel II framework, but some of the principles of Basel II will apply to all banking organizations. One such principle is a reliance on external credit ratings by NRSROs as a basis for determining counterparty risk. The other financial regulatory agencies have stated that they also expect to consider possible changes to their risk-based capital regulations for banking organizations not subject to the advanced Basel II framework. They expect that these changes would become effective at the same time as the framework-based regulations.<sup>14</sup>

Since 2001, even before Basel II was finalized, the other financial regulatory agencies have amended their risk-based capital regulations consistent with the ratings-based approach of Basel II. Most relevant to our final rule, in November 2001 the other financial regulatory agencies published a rule<sup>15</sup> that bases the capital requirements for positions that banking organizations<sup>16</sup> hold in recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities<sup>17</sup> on the relative credit exposure of these positions, as measured by external credit ratings received from an NRSRO.<sup>18</sup> Similarly, in April 2002, the other financial regulatory agencies published a rule<sup>19</sup> that bases the capital

requirements for claims on or guaranteed by securities firms on their relative risk exposure as measured by external credit ratings from NRSROs. The other financial regulatory agencies have also applied the ratings-based approach to other credit exposures, consistent with the approach of Basel II.

#### D. Scope of FCA's Rulemaking

Just as the other financial regulatory agencies have adopted risk-based rules, consistent with the approach of Basel II, that are relevant for the banking organizations that they regulate, the FCA has proposed and adopted rules tailored to activities of the FCS. Our intention is to align our risk-based capital framework with the rules of the other financial regulatory agencies where appropriate, but also to recognize areas where differences are warranted. For example, this rule places emphasis on capital treatment of investments in ABS and MBS held for liquidity. In contrast, the rules of the other financial regulatory agencies focus on traditional securitization activities, where a banking organization sells assets or credit exposures to increase its liquidity and manage credit risk.

As the other financial regulatory agencies have done, we are making explicit our existing authority to modify a specified risk weight if it does not accurately reflect the actual risk.

### III. Overview

#### A. General Approach

These revisions to our capital rules implement a ratings-based approach for risk-weighting positions in recourse obligations, residual interests (other than credit-enhancing interest-only strips), direct credit substitutes, and asset- and mortgage-backed securities. Highly rated positions will receive a favorable (less than 100-percent) risk weighting. Positions that are rated below investment grade<sup>20</sup> will receive a less favorable risk weighting. The FCA will apply this approach to positions based on their inherent risks rather than how they might be characterized or labeled.

As noted, this ratings-based approach provides risk weightings for a variety of assets that have a wide range of credit ratings. We provide risk weightings for investments that are rated below investment grade, although they are not eligible investments under our current investment regulations.<sup>21</sup> This rule does not, however, expand the scope of eligible investments. It merely explains

how to risk weight an investment that was eligible when purchased if its credit rating subsequently deteriorates. Such investments must still be disposed of in accordance with § 615.5143.<sup>22</sup>

#### B. Asset Securitization

Understanding this rule requires an understanding of asset securitization and other structured transactions that are used as tools to manage and transfer credit risk. Therefore, we have included the following background explanation to aid our readers.

Asset securitization is the process by which loans or other credit exposures are pooled and reconstituted into securities, with one or more classes or positions that may then be sold. Securitization provides an efficient mechanism for institutions to sell loan assets or credit exposures and thereby to increase the institution's liquidity.

Securitized assets typically carve up the risk of credit losses from the underlying assets and distribute it to different parties. The "first dollar," or most subordinate, loss position is first to absorb credit losses; the most "senior" investor position is last to absorb losses; and there may be one or more loss positions in between ("second dollar" loss positions). Each loss position functions as a credit enhancement for the more senior positions in the structure.

Recourse, in connection with sales of whole loans or loan participations, is now frequently associated with asset securitizations. Depending on the type of securitization, the sponsor of a securitization may provide a portion of the total credit enhancement internally, as part of the securitization structure, through the use of excess spread accounts, overcollateralization, retained subordinated interests, or other similar on-balance sheet assets. When these or other on-balance sheet internal enhancements are provided, the enhancements are "residual interests" for regulatory capital purposes.

A seller may also arrange for a third party to provide credit enhancement<sup>23</sup> in an asset securitization. If another financial institution provides the third-party enhancement, then that institution assumes some portion of the assets' credit risk. In this proposed rule, all

<sup>22</sup> Section 615.5143 provides that an institution must dispose of an ineligible investment within 6 months unless FCA approves, in writing, a plan that authorizes divestiture over a longer period of time. An institution must dispose of an ineligible investment as quickly as possible without substantial financial loss.

<sup>23</sup> The terms "credit enhancement" and "enhancement" refer to both recourse arrangements (including residual interests) and direct credit substitutes.

<sup>11</sup> See Interagency Statement—U.S. Implementation of Basel II Framework: Qualification Process—IRB and AMA (Jan. 27, 2005).

<sup>12</sup> See Joint Press Release, Banking Agencies to Perform Additional Analysis Before Issuing Notice of Proposed Rulemaking Related to Basel II (April 29, 2005).

<sup>13</sup> *Id.*

<sup>14</sup> See Interagency Statement—U.S. Implementation of Basel II Framework: Qualification Process—IRB and AMA (January 27, 2005).

<sup>15</sup> 66 FR 59614 (November 29, 2001).

<sup>16</sup> Banking organizations include banks, bank holding companies, and thrifts. See 66 FR 59614 (November 29, 2001).

<sup>17</sup> See 66 FR 59614 (November 29, 2001).

<sup>18</sup> An NRSRO is a rating organization that the Securities and Exchange Commission recognizes as an NRSRO. See new FCA regulation 12 CFR 615.5201.

<sup>19</sup> 67 FR 16971 (April 9, 2002).

<sup>20</sup> Investment grade means a credit rating of AAA, AA, A or BBB or equivalent by an NRSRO.

<sup>21</sup> See § 615.5140.

forms of third-party enhancements, *i.e.*, all arrangements in which an FCS institution assumes credit risk from third-party assets or other claims that it has not transferred, are referred to as "direct credit substitutes."

Many asset securitizations use a combination of recourse and third-party enhancements to protect investors from credit risk. When third-party enhancements are not provided, the institution ordinarily retains virtually all of the credit risk on the assets.

### C. Risk Management

While asset securitization can enhance both credit availability and profitability, managing the risks associated with this activity poses significant challenges. While not new to FCS institutions, these risks may be less obvious and more complex than traditional lending activities. Specifically, securitization can involve credit, liquidity, operational, legal, and reputation risks that may not be fully recognized by management or adequately incorporated into risk management systems. The capital treatment required by this proposed rule addresses credit risk associated with securitizations and other credit risk mitigation techniques. Therefore, it is essential that an institution's compliance with capital standards be complemented by effective risk management practices and strategies.

Similar to the other financial regulatory agencies, the FCA expects FCS institutions to identify, measure, monitor, and control securitization risks and explicitly incorporate the full range of those risks into their risk management systems. The board and management are responsible for adequate policies and procedures that address the economic substance of their activities and fully recognize and ensure appropriate management of related risks. Additionally, FCS institutions must be able to measure and manage their risk exposure from securitized positions, either retained or acquired. The formality and sophistication with which the risks of these activities are incorporated into an institution's risk management system should be commensurate with the nature and volume of its securitization activities.<sup>24</sup>

### IV. The Ratings-Based Approach for Government-Sponsored Agencies and OECD Banks

Under our proposal, beginning 18 months after the effective date of the

<sup>24</sup> This rule does not grant any new authorities to System institutions. It merely provides risk weightings for investments and transactions that are otherwise authorized.

final rule, the ratings-based approach would have applied to assets covered by credit protection provided by Government-sponsored agencies and OECD banks, including credit derivatives (*e.g.*, credit default swaps), loss purchase commitments, guarantees and other similar arrangements. In addition, the ratings-based approach would have applied to unrated positions in recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset- or mortgage-backed securities that are guaranteed by Government-sponsored agencies beginning 18 months after the final rule's effective date.

As we noted in the preamble to our proposed rule, the other financial regulatory agencies have not yet implemented the ratings-based approach for assets covered by credit protection provided by Government-sponsored agencies or OECD banks or for positions in securitizations guaranteed by Government-sponsored agencies. However, we proposed these provisions as a limited implementation of the Basel II framework. Further, we cited because of our concern that claims of this nature on any counterparties that are not highly rated or are unrated, including Government-sponsored agencies and OECD banks, may pose significant risks to FCS institutions. In particular, we expressed our concern about the unique structural and operational risks that these types of claims may present.

In addition, we noted in the preamble to the proposed rule that the United States General Accounting Office (GAO)<sup>25</sup> recently recommended that the FCA "[c]reate a plan to implement actions currently under consideration to reduce potential safety and soundness issues that may arise from capital arbitrage activities of Farmer Mac and FCS institutions."<sup>26</sup> Our proposal stated that the rule would help ensure that FCS institutions could not alter their capital requirements simply by using different structures, arrangements, or counterparties without changing the nature of the risks they assume or retain.

We received letters opposing these provisions from nine commenters. In brief, the commenters made the following points:

- The other financial regulatory agencies have not implemented the

<sup>25</sup> This agency has been renamed the Government Accountability Office.

<sup>26</sup> United States General Accounting Office, Farmer Mac: Some Progress Made, but Greater Attention to Risk Management, Mission, and Corporate Governance Is Needed, GAO-04-116, at page 59 (2003).

ratings-based approach for their regulated financial institutions for claims of this nature on Government-sponsored agency counterparties, and therefore the FCA's requirements would put System institutions at a competitive disadvantage.

- Applying the ratings-based approach to claims of this nature on Government-sponsored agencies would discourage System institutions from using such agencies as a tool to enhance safety and soundness and to manage risk. In particular, it would discourage the use of Farmer Mac programs, which could hinder both the System's and Farmer Mac's ability to further their mission to serve agriculture and could jeopardize the financial viability of Farmer Mac.

- The proposed regulation, which would permit a 20-percent risk weighting for a claim of this nature on a Government-sponsored agency or OECD bank counterparty only if the agency or bank has an AAA or AA issuer credit rating, is inconsistent with other FCA regulations, including its rule governing other financing institutions (OFIs) and its proposed rule governing Investments in Farmers' Notes.<sup>27</sup> In addition, under the proposed rule, investments in debt obligations of a Government-sponsored agency would be risk weighted at 20 percent regardless of issuer credit rating, even though these investments are not backed by mortgages, unlike the investments that would be subject to the ratings-based approach.

- The proposed rule is an ad hoc implementation of Basel II; FCA should wait to see what approach the other Federal financial regulators are going to adopt before implementing any components of Basel II.

- FCA could better achieve its purpose of limiting counterparty risk by establishing counterparty exposure limits.

We have removed these provisions related to Government-sponsored agencies and OECD banks from the final rule. We believe it is prudent to wait for the other financial regulatory agencies to announce the approach they plan to take so that any competitive disadvantage due to inconsistent risk-weighting requirements can be avoided. We are continuing to evaluate the progress of the other financial regulatory agencies toward implementing Basel II and to determine the appropriate

<sup>27</sup> Both the OFI rule and the proposed Farmers' Notes rule permit a 20-percent risk weighting if the counterparty is an OECD bank, regardless of issuer credit rating, or if the counterparty has at least an A credit rating. See 69 FR 29852 (May 26, 2004); 69 FR 55362 (Sept. 14, 2004).

implementation for the System. As Basel II is implemented throughout the banking world, we expect to revisit our approach to risk weighting. Thus, System institutions should anticipate additional regulatory capital amendments, consistent with Basel II, over the next few years.

In the meantime, when appropriate, as we have emphasized, we will exercise our reservation of authority to modify the risk-weighting requirements (which could result in a higher or lower risk weight) for any asset or off-balance sheet item when its capital treatment does not accurately reflect its associated risk.

As we have also emphasized, transactions or arrangements involving credit protection such as credit derivatives, loss purchase commitments, guarantees and the like often contain a number of structural complexities and may impose additional operational and counterparty risk on FCS institutions that enter into them. Accordingly, FCS institutions should ensure their counterparties are sophisticated, financially strong, and well capitalized. Moreover, FCS institutions must fully understand the risks transferred, retained, or assumed through these arrangements. We expect FCS institutions to take appropriate measures to manage the additional operational risks that may be created by these arrangements. FCS institutions should thoroughly review and understand all the legal definitions and parameters of these instruments, including credit events that constitute default, as well as representations and warranties, to determine how well the contract will perform under a variety of economic conditions. We also advise FCS institutions to review FCA's Informational Memorandum dated October 21, 2003, in which the Agency suggested items for consideration in managing counterparty risk.

## V. Section-by-Section Analysis of Rule

The following discussion provides explanations, where necessary, of the more complex changes this rule makes. Most of the changes are necessary to align our rules more closely with those of the other financial regulatory agencies and to recognize relative risk exposure. As mentioned above, we have also made a number of organizational and plain language changes to make our rules easier to follow. These changes are discussed later in this preamble.

### A. Section 615.5201—Definitions

Because this rule implements a new risk-weighting approach for recourse obligations, residual interests, direct

credit substitutes, and other securitization arrangements, we are amending § 615.5201 to add a number of new definitions relating to these activities. We are updating certain other definitions as warranted. For the most part, to achieve consistency with the other financial regulatory agencies, we are adopting the same definitions as the other agencies.

#### 1. Credit Derivative

We define “credit derivative” as a contract that allows one party (the protection purchaser) to transfer the credit risk of an asset or off-balance sheet credit exposure to another party (the protection provider). The value of a credit derivative is dependent, at least in part, on the credit performance of a “reference asset.”

The definitions of “recourse” and “direct credit substitute” cover credit derivatives to the extent that an institution's credit risk exposure exceeds its pro rata interest in the underlying obligation. The ratings-based approach therefore applies to rated instruments such as credit-linked notes issued as part of a synthetic securitization.

Credit derivatives can have a variety of structures. Therefore, we will continue to evaluate the risk weighting of credit derivatives on a case-by-case basis. Furthermore, we will continue to use the November 1999 and December 1999 guidance on synthetic securitizations issued by the Federal Reserve Board and the OCC as a guide for determining appropriate capital requirements for FCS institutions and continue to apply the structural and risk management requirements outlined in the 1999 guidance.<sup>28</sup>

#### 2. Credit-Enhancing Interest-Only Strip

We define the term “credit-enhancing interest-only strip” as an on-balance sheet asset that, in form or in substance, (1) Represents the contractual right to receive some or all of the interest due on transferred assets; and (2) exposes the institution to credit risk directly or indirectly associated with the transferred assets that exceeds its pro rata claim on the assets, whether through subordination provisions or other credit enhancement techniques. FCA reserves the right to identify other cash flows or related interests as credit-enhancing interest-only strips based on the economic substance of the transaction.

<sup>28</sup> See Banking Bulletin 99-43, December 1999 (OCC); Supervision and Regulation Letter 99-32, Capital Treatment for Synthetic Collateralized Loan Obligations, November 15, 1999 (Federal Reserve Board).

Credit-enhancing interest-only strips include any balance sheet asset that represents the contractual right to receive some or all of the remaining interest cash flow generated from assets that have been transferred into a trust (or other special purpose entity), after taking into account trustee and other administrative expenses, interest payments to investors, servicing fees, and reimbursements to investors for losses attributable to the beneficial interests they hold, as well as reinvestment income and ancillary revenues<sup>29</sup> on the transferred assets.

Credit-enhancing interest-only strips are generally carried on the balance sheet at the present value of the reasonably expected net cash flow, adjusted for some level of prepayments if relevant, and discounted at an appropriate market interest rate. As mentioned earlier, FCA will look to the economic substance of the transaction and reserves the right to identify other cash flows or spread-related assets as credit-enhancing interest-only strips on a case-by-case basis. For example, including some principal payments with interest and fee cash flows will not otherwise negate the regulatory capital treatment of that asset as a credit-enhancing interest-only strip. Credit-enhancing interest-only strips include both purchased and retained interest-only strips that serve in a credit-enhancing capacity, even though purchased interest-only strips generally do not result in the creation of capital on the purchaser's balance sheet.

#### 3. Credit-Enhancing Representations and Warranties

When an institution transfers or purchases assets, including servicing rights, it customarily makes or receives representations and warranties concerning those assets. These representations and warranties give certain rights to other parties and impose obligations upon the seller or servicer of those assets. To the extent such representations and warranties function as credit enhancements to protect asset purchasers or investors from credit risk, the rule treats them as recourse or direct credit substitutes.

More specifically, “credit-enhancing representations and warranties” are defined as representations and warranties that: (1) Are made or assumed in connection with a transfer of assets (including loan-servicing assets); and (2) obligate an institution to protect investors from losses arising

<sup>29</sup> Under Statement of Financial Accounting Standards No. 140, ancillary revenues include late charges on transferred assets.

from credit risk in the assets transferred or loans serviced. The term includes promises to protect a party from losses resulting from the default or nonperformance of another party or from an insufficiency in the value of collateral.

This definition is consistent with the other financial regulatory agencies' long-standing recourse treatment of representations and warranties that effectively guarantee performance or credit quality of transferred loans. However, a number of factual warranties unrelated to ongoing performance or credit quality are typically made. These warranties entail operational risk, as opposed to credit risk inherent in a financial guaranty, and are excluded from the definitions of recourse and direct credit substitute. Warranties that create operational risk include warranties that assets have been underwritten or collateral appraised in conformity with identified standards and warranties that permit the return of assets in instances of incomplete documentation, misrepresentation, or fraud. FCA expects FCS institutions to be able to demonstrate effective management of operational risks created by warranties.

Warranties or assurances that are treated as recourse or direct credit substitutes include warranties on the actual value of asset collateral or that ensure the market value corresponds to appraised value or the appraised value will be realized in the event of foreclosure and sale. Also, premium refund clauses, which can be triggered by defaults, are generally credit enhancements. A premium refund clause is a warranty that obligates the seller who has sold a loan at a price in excess of par, *i.e.*, at a premium, to refund the premium, either in whole or in part, if the loan defaults or is prepaid within a certain period of time. However, certain premium refund clauses are not considered credit enhancements, including:

(1) Premium refund clauses covering loans for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of the transfer; and

(2) Premium refund clauses covering assets guaranteed, in whole or in part, by the United States Government, a United States Government agency, or a United States Government-sponsored agency, provided the premium refund clause is for a period not to exceed 120 days from the date of transfer.

Clean-up calls, an option that permits a servicer or its affiliate to take investors out of their positions prior to repayment

of all loans, are also generally treated as credit enhancements. A clean-up call is not considered recourse or a direct credit substitute only if the agreement to repurchase is limited to 10 percent or less of the original pool balance. Repurchase of any loans 30 days or more past due would invalidate this exemption.

Similarly, a loan-servicing arrangement is considered as recourse or a direct credit substitute if the institution, as servicer, is responsible for credit losses associated with the serviced loans. However, a cash advance made by a servicer to ensure an uninterrupted flow of payments to investors or the timely collection of the loans is specifically excluded from the definitions of recourse and direct credit substitute, provided that the servicer is entitled to reimbursement for any significant advances and this reimbursement is not subordinate to other claims. To be excluded from recourse and direct credit substitute treatment, an independent credit assessment of the likelihood of repayment of the servicer's cash advance should be made prior to advancing funds, and the institution should only make such an advance if prudent lending standards are met.

#### 4. Direct Credit Substitute

The definition of "direct credit substitute" complements the definition of "recourse." The term "direct credit substitute" refers to an arrangement in which an institution assumes, in form or in substance, credit risk directly or indirectly associated with an on- or off-balance sheet asset or exposure that was not previously owned by the institution (third-party asset) and the risk assumed by the institution exceeds the pro rata share of the institution's interest in the third-party asset. If the institution has no claim on the third-party asset, then the institution's assumption of any credit risk is a direct credit substitute. The term explicitly includes items such as the following:

- Financial standby letters of credit that support financial claims on a third party that exceed an institution's pro rata share in the financial claim;
- Guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed an institution's pro rata share in the financial claim;
- Purchased subordinated interests that absorb more than their pro rata share of losses from the underlying assets;
- Credit derivative contracts under which the institution assumes more

than its pro rata share of credit risk on a third-party asset or exposure;

- Loans or lines of credit that provide credit enhancement for the financial obligations of a third party;

- Purchased loan-servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced (servicer cash advances are not direct credit substitutes); and

- Clean-up calls on third-party assets. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the institution are not direct credit substitutes.

#### 5. Externally Rated

The rule defines "externally rated" to mean that an instrument or obligation has received a credit rating from at least one NRSRO. The use of external credit ratings provides a way to determine credit quality relied upon by investors and other market participants to differentiate the regulatory capital treatment for loss positions representing different gradations of risk. This use permits more equitable treatment of transactions and structures in administering the risk-based capital requirements.

#### 6. Financial Standby Letter of Credit

Section 615.5201(o) of our regulations previously defined the term "standby letter of credit." We are changing the term to "financial standby letter of credit" to conform our term to that used by the other financial regulatory agencies. We are making no substantive changes to the definition.

#### 7. Government Agency

The term "Government agency" was defined in two places in our previous capital regulations: § 615.5201(f), the definitions section, and § 615.5210(f)(2)(i)(D), which was the section on computing the permanent capital ratio. We have modified the previous § 615.5201(f) definition by replacing it with the definition of Government agency previously in § 615.5210(f)(2)(i)(D) and have deleted the definition in previous § 615.5210(f)(2)(i)(D). We believe these changes streamline the regulation. We do not intend to change the meaning of this term.

#### 8. Government-Sponsored Agency

The term "Government-sponsored agency" was also defined in two places in our previous capital regulations (§ 615.5201(g), the definitions section,

and § 615.5210(f)(2)(ii)(A), the former section on computing the permanent capital ratio). We have modified the previous definition in § 615.5201(g) by replacing it with the previous § 615.5210(f)(2)(ii)(A) definition of Government-sponsored agency (amended slightly for clarity, as discussed below) and have deleted the redundant definition in previous § 615.5210(f)(2)(ii)(A). This change simply streamlines our regulations and does not change the meaning of the term.

“Government-sponsored agency” is defined 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 guaranteed by the full faith and credit of the United States Government, including but not limited to any Government-sponsored enterprise (GSE). This definition includes GSEs such as Fannie Mae and Farmer Mac, as well as Federal agencies, such as the Tennessee Valley Authority, that issue obligations that are not explicitly guaranteed by the United States’ full faith and credit. This definition is slightly different from that in our proposal, although the meaning is the same; we have clarified that the term includes corporations, as well as agencies or instrumentalities, that are chartered or established to serve public purposes specified by Congress, and also that the term includes GSEs. This information was provided in the preamble to the proposed rule but was not explicitly stated in the rule itself.

#### 9. Nationally Recognized Statistical Rating Organization

We define “nationally recognized statistical rating organization” (NRSRO) as a rating organization that the Securities and Exchange Commission (SEC) recognizes as an NRSRO. This definition is identical to the definition in § 615.5131(j) of our regulations.

#### 10. Non-OECD Bank

We define “non-OECD bank” as a bank and its branches (foreign and domestic) organized under the laws of a country that does not belong to the OECD group of countries.<sup>30</sup>

<sup>30</sup> 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. For purposes of our capital regulations, as well as those of the other financial regulatory agencies and the Basel Accord, OECD countries are those countries that are full members of the OECD or that have concluded special lending arrangements associated with the International Monetary Fund’s General Arrangements to Borrow, excluding any country that has rescheduled its

#### 11. OECD Bank

We define “OECD bank” as a bank and its branches (foreign and domestic) organized under the laws of a country that belongs to the OECD group of countries. For purposes of our capital regulations, this term includes U.S. depository institutions.

#### 12. Permanent Capital

We add language to clarify that permanent capital is subject to adjustments such as dollar-for-dollar reduction of capital for residual interests or other high-risk assets as described in new § 615.5207. We made no other changes.

#### 13. Recourse

The rule defines the term “recourse” to mean an arrangement in which an institution retains, in form or in substance, any credit risk directly or indirectly associated with an asset it has sold (in accordance with generally accepted accounting principles (GAAP)) that exceeds a pro rata share of the institution’s claim on the asset. If an institution has no claim on an asset it has sold, then the retention of any credit risk is recourse. A recourse obligation typically arises when an institution transfers assets in a sale and retains an explicit obligation to repurchase assets or to absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if an institution provides credit enhancement beyond any contractual obligation to support assets it has sold.

Our definition of recourse is consistent with the other regulators’ long-standing use of this term and incorporates existing practices regarding retention of risk in asset sales. The other financial regulatory agencies have noted that third-party enhancements, such as insurance protection, purchased by the originator of a securitization for the benefit of investors, do not constitute recourse. The purchase of enhancements for a securitization or other structured transaction where the institution is completely removed from any credit risk will not, in most instances, constitute recourse. However, if the purchase or premium price is paid over time and the size of the payment is a function of the third party’s loss experience on the portfolio, such an arrangement indicates an assumption of

external sovereign debt within the previous 5 years. The OECD currently has 30 member countries. An up-to-date listing of member countries is available at <http://www.oecd.org> or [www.oecdwash.org](http://www.oecdwash.org).

credit risk and would be considered recourse.

#### 14. Residual Interest

The rule defines “residual interest” as any on-balance sheet asset that: (1) Represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with GAAP) of financial assets, whether through a securitization or otherwise; and (2) exposes an institution to credit risk directly or indirectly associated with the transferred asset that exceeds a pro rata share of that institution’s claim on the asset, whether through subordination provisions or other credit enhancement techniques.

Residual interests generally include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests (and other forms of overcollateralization), and similar assets that function as a credit enhancement. Residual interests generally do not include interests purchased from a third party. However, a purchased credit-enhancing interest-only strip is a residual interest because of its similar risk profile.

This functional definition reflects the fact that financial structures vary in the way they use certain assets as credit enhancements. Therefore, residual interests include any retained on-balance sheet asset that functions as a credit enhancement in a securitization or other structured transaction, regardless of its characterization in financial or regulatory reports.

#### 15. Rural Business Investment Company

The rule adds a definition for “Rural Business Investment Company” (RBIC). Section 6029 of the Farm Security and Rural Investment Act of 2002<sup>31</sup> amended the Consolidated Farm and Rural Development Act, as amended (7 U.S.C. 1921 *et seq.*) by adding a new subtitle H, establishing a new “Rural Business Investment Program.” The new subtitle permits FCS institutions to establish or invest in RBICs, subject to specified limitations. We define RBICs by referring to the statutory definition codified in 7 U.S.C. 2009cc(14). That provision defines RBIC as “a company that (A) has been granted final approval by the Secretary [of Agriculture] \* \* \* and; (B) has entered into a participation agreement with the Secretary [of Agriculture].”

#### 16. Securitization

The rule defines “securitization” as the pooling and repackaging by a special

<sup>31</sup> Pub. L. 107–171.

purpose entity or trust of assets or other credit exposures that can be sold to investors. Securitization includes transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

17. Other Terms

We also add definitions for the following terms:

- Bank.
- Face Amount.
- Financial Asset.
- Qualified Residential Loan.
- Qualifying Securities Firm.
- Risk Participation.
- Servicer Cash Advance.
- Traded Position.
- U.S. Depository Institution.

Finally, we carry over the remaining definitions from the previous rule without substantive change.

*B. Sections 615.5210 and 615.5211—Ratings-Based Approach for Positions in Securitizations*

1. Sections 615.5210 and 615.5211—General

As described in the overview section of this preamble, each loss position in an asset securitization structure functions as a credit enhancement for the more senior loss positions in the structure. Historically, neither our risk-based capital standards nor those of the other financial regulatory agencies varied the capital requirements for different credit enhancements or loss positions to reflect differences in the relative credit risks represented by the positions. To address this issue, the other financial regulatory agencies implemented a multilevel, ratings-based approach to assess capital requirements on recourse obligations, residual interests (except credit-enhancing

interest-only strips), direct credit substitutes, and senior and subordinated positions in asset-backed securities and mortgage-backed securities based on their relative exposure to credit risk. The approach uses credit ratings from NRSROs to measure relative exposure to credit risk and determine the associated risk-based capital requirement.

With this rule, we are adopting similar requirements. These changes bring our regulations into close alignment with those of the other financial regulatory agencies for externally rated positions in securitizations with similar risks.

Additionally, new § 615.5210(f) of the regulation makes explicit FCA’s authority to override the use of certain ratings or the ratings on certain instruments, either on a case-by-case basis or through broader supervisory policy, if necessary or appropriate to address the risk that an instrument poses to FCS institutions.

2. Section 615.5210(b)—Positions that Qualify for the Ratings-Based Approach

Under new § 615.5210(b) of our rule, certain positions in securitizations qualify for the ratings-based approach. These positions in securitizations are eligible for the ratings-based approach, provided the positions have favorable external ratings (as explained below) by at least one NRSRO.

More specifically, the following positions in securitizations qualify for the ratings-based approach if they satisfy the criteria set forth below:

- Recourse obligations;
- Direct credit substitutes;
- Residual interests (other than credit-enhancing interest-only strips);<sup>32</sup> and
- Asset- and mortgage-backed securities.

3. Section 615.5210(b)—Application of the Ratings-Based Approach

Under new § 615.5210, the capital requirement for a position that qualifies for the ratings-based approach is computed by multiplying the face amount of the position by the appropriate risk weight as determined by the position’s external credit rating.

Under new § 615.5210(b), a position that is traded and externally rated qualifies for the ratings-based approach if its long-term external rating is one grade below investment grade or better (e.g., BB or better) or its short-term external rating is investment grade or better (e.g., A–3, P–3).<sup>33</sup> If the position receives more than one external rating, the lowest rating would apply. This requirement eliminates the potential for rating shopping.

A position that is externally rated but not traded qualifies for the ratings-based approach if it satisfies the following criteria:

- It must be externally rated by more than one NRSRO;
- Its long-term external rating must be one grade below investment grade or better (e.g., BB or better) or its short-term external rating must be investment grade or better (e.g., A–3, P–3). If the position receives more than one external rating, the lowest rating would apply;
- The ratings must be publicly available; and
- The ratings must be based on the same criteria used to rate traded positions.

Under the ratings-based approach, the capital requirement for a position that qualifies for the ratings-based approach is computed by multiplying the face amount of the position by the appropriate risk weight determined in accordance with the following tables:<sup>34</sup>

RISK-BASED CAPITAL REQUIREMENTS FOR LONG-TERM ISSUE OR ISSUER RATINGS

Rating category	Rating examples <sup>35</sup>	Risk weight (in percent)
Highest or second highest investment grade .....	AAA or AA .....	20
Third highest investment grade .....	A .....	50
Lowest investment grade .....	BBB .....	100
One category below investment grade .....	BB .....	200
More than one category below investment grade, or unrated .....	B or below or Unrated .....	Not eligible for the ratings-based approach.

<sup>32</sup> We exclude credit-enhancing interest-only strips from the ratings-based approach because of their high-risk profile, as discussed under section V.C.1. of this preamble.

<sup>33</sup> These ratings are examples only. Different NRSROs may have different ratings for the same grade.

<sup>34</sup> See paragraphs (b)(13), (c)(3), (d)(6), and (e) of new § 615.5211.

<sup>35</sup> These ratings are examples only. Different NRSROs may have different ratings for the same grade. Further, ratings are often modified by either a plus or minus sign to show relative standing within a major rating category. Under the proposed

rule, ratings refer to the major rating category without regard to modifiers. For example, an investment with a long-term rating of “A–” would be risk weighted at 50 percent.



## RISK-BASED CAPITAL REQUIREMENTS FOR SHORT-TERM ISSUE RATINGS

Short-term rating category	Rating examples	Risk weight (in percent)
Highest investment grade .....	A-1, P-1 .....	20
Second highest investment grade .....	A-2, P-2 .....	50
Lowest investment grade .....	A-3, P-3 .....	100
Below investment grade, or unrated .....	B or lower (Not Prime) .....	Not eligible for the ratings-based approach.

The charts for long-term and short-term ratings are not identical because rating agencies use different methodologies. Each short-term rating category covers a range of longer-term rating categories. For example, a P-1 rating could map to a long-term rating as high as Aaa or as low as A3.

These amendments do not change the risk-weight requirement that FCA adopted in its interim final rule for non-agency asset- and mortgage-backed securities that are highly rated.<sup>36</sup> These amendments simply make our rule language more consistent with that used by the other financial regulatory agencies for these types of transactions.

*C. Section 615.5210(c)—Treatment of Positions in Securitizations That Do Not Qualify for the Ratings-Based Approach*

1. Section 615.5210(c)(1), (c)(2), and (c)(3)—Positions Subject to Dollar-for-Dollar Capital Treatment

This rule subjects certain positions in asset securitizations that do not qualify for the ratings-based approach to dollar-for-dollar capital treatment. As set forth in new paragraphs 615.5210(c)(1), (c)(2), and (c)(3), these positions include:

- Residual interests that are not externally rated;
- Credit-enhancing interest-only strips; and
- Positions that have long-term external ratings that are two grades below investment grade or lower (e.g., B or lower) or short-term external ratings that are one grade below investment grade or lower (e.g., B or lower, Not Prime).

Under the dollar-for-dollar treatment, an FCS institution must deduct from capital and assets the face amount of the position. This means, in effect, one dollar in total capital must be held against every dollar held in these positions, even if this capital requirement exceeds the full risk-based capital charge.

We adopt the dollar-for-dollar treatment for the credit-enhancing and highly subordinated positions listed above because these positions raise a number of supervisory concerns that the

other financial regulatory agencies also share.<sup>37</sup> The level of credit risk exposure associated with deeply subordinated assets, particularly subinvestment grade and unrated residual interests, is extremely high. They are generally subordinated to all other positions, and these assets are subject to valuation concerns that might lead to loss as explained further below. Additionally, the lack of an active market makes these assets difficult to independently value and relatively illiquid.

In particular, there are a number of concerns regarding residual interests. A banking organization can inappropriately generate “paper profits” (or mask actual losses) through incorrect cash flow modeling, flawed loss assumptions, inaccurate prepayment estimates, and inappropriate discount rates. Such practices often lead to an inflation of capital, falsely making the banking organization appear more financially sound. Also, embedded within residual interests, including credit-enhancing interest-only strips, is a significant level of credit and prepayment risk that make their valuation extremely sensitive to changes in underlying assumptions. For these reasons we, like the other financial regulatory agencies, concluded that a higher capital requirement is warranted for unrated residual interests and all credit-enhancing interest-only strips. Furthermore, the “low-level exposure rule,” discussed below, does not apply to these positions in securitizations. For example, if an FCS institution holds a non-externally rated 10-percent residual interest in \$100 million of loans sold into a securitization, the institution’s capital charge would be \$10 million. If an FCS institution purchases a \$25 million position in an ABS that is subsequently downgraded to B or lower, its capital charge would be \$25 million, the full amount of the position.

We note that the final rules adopted by the other financial regulatory agencies impose both a dollar-for-dollar risk weighting for residual interests that do not qualify for the ratings-based approach and a concentration limit on

a subset of those residual interests—credit-enhancing interest-only strips—for the purpose of calculating a bank’s leverage ratio. Under their combined approach, credit-enhancing interest-only strips are limited to 25 percent of a banking organization’s Tier 1 capital. Everything above that amount is deducted from Tier 1 capital. Generally, under the other financial regulatory agencies’ rules, all other residual interests that do not qualify for the ratings-based approach (including any credit-enhancing interest-only strips that were not deducted from Tier 1 capital) are subject to a dollar-for-dollar risk weighting. The combined capital charge is limited to the face amount of a banking organization’s residual interests.

As indicated previously, we are adopting a one-step approach for these positions in securitizations. This requires FCS institutions to deduct from capital and assets the face amount of their position. The resulting total capital charge is virtually the same under both approaches. However, we found that the one-step approach is easier to apply to FCS institutions because the way they compute their regulatory capital standards differs from the way other banking organizations compute their standards.

2. Section 615.5210(c)(4)—Unrated Recourse Obligations and Direct Credit Substitutes

As discussed in the definitions section, the contractual retention of credit risk by an FCS institution associated with assets it has sold generally constitutes recourse.<sup>38</sup> The definitions of recourse and direct credit substitute complement each other, and there are many types of recourse arrangements and direct credit substitutes that can be assumed through either on- or off-balance sheet credit exposures that are not externally rated.

<sup>38</sup> As previously discussed, this rule defines the term “recourse” to mean an arrangement in which an institution retains, in form or in substance, any credit risk directly or indirectly associated with an asset it has sold, if the credit risk exceeds a pro rata share of the institution’s claim on the asset. If an institution has no claim on an asset that it has sold, then the retention of any credit risk is recourse.

<sup>36</sup> See 68 FR 15045 (March 28, 2003).

<sup>37</sup> See 66 FR 59614 (November 29, 2001).



Under new § 615.5210(c)(4), FCS institutions are required to hold capital against the entire outstanding amount of assets supported (e.g., all more senior positions) by an on-balance sheet recourse obligation or direct credit substitute that is unrated. This treatment parallels our approach for off-balance sheet recourse obligations and direct credit substitutes, as discussed later under the computation of credit equivalent amounts. For example, if an FCS institution retains an on-balance sheet first-loss position through a recourse arrangement or direct credit substitute in a pool of rural housing loans that qualify for a 50-percent risk weight, the FCS institution would include the full amount of the assets in the pool, risk weighted at 50 percent, in its risk-weighted assets for purposes of determining its risk-based capital ratios. The low-level exposure rule<sup>39</sup> provides that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which an FCS institution is contractually liable.

The other financial regulatory agencies currently permit their banking organizations to use three alternative approaches (i.e., internal ratings, program ratings, and computer programs) for determining the capital requirements for certain unrated direct credit substitutes and recourse obligations in asset-backed commercial paper programs. As discussed in the preamble to our proposed rule, the FCA has decided not to address the capital requirements for asset-backed commercial paper programs at this time due to the limited involvement FCS institutions presently have in these programs. FCA will continue to determine the capital requirements for such programs on a case-by-case basis.

#### 3. Sections 615.5210(c)(5) and 615.5211(d)(7)—Stripped Mortgage-Backed Securities (SMBS)

Under new §§ 615.5210(c)(5) and 615.5211(d)(7), SMBS and similar instruments, such as interest-only strips that are not credit-enhancing or principal-only strips (including such instruments guaranteed by Government-sponsored agencies), are assigned to the 100-percent risk-weight category. Even if highly rated, these securities do not receive the more favorable capital treatment available to other mortgage securities because of their higher market risk profile. Typically, SMBS contain a higher degree of price volatility

associated with mortgage prepayments.<sup>40</sup>

#### 4. Section 615.5211(d)(12)—Unrated Positions in Asset-Backed Securities and Mortgage-Backed Securities

Unrated positions in mortgage- and asset-backed securities that do not qualify for the ratings-based approach are generally assigned to the 100-percent risk-weight category under this rule.

The FCA recognizes that these risk-based capital requirements can provide a more favorable treatment for certain unrated positions in asset- and mortgage-backed securities than those rated below investment grade. For this reason, FCA will look to the substance of the transaction to determine whether a higher capital requirement is warranted based on the risk characteristics of the position. Additionally, because of the many advantages, including pricing, liquidity, and favorable capital treatment on highly rated positions in asset- and mortgage-backed securities, we believe this overall regulatory approach does not provide a disincentive for participants to obtain external ratings.

#### D. Section 615.5210(d)—Senior Positions Not Externally Rated

For senior positions not externally rated, the following capital treatment applies under new § 615.5210(d). If an FCS institution retains an unrated position that is senior or preferred in all respects (including collateral and maturity) to a rated position that is traded, the position is treated as if it had the same rating assigned to the rated position. These senior unrated positions qualify for the risk weighting of the subordinated rated positions as long as the subordinate rated position is traded and remains outstanding for the entire life of the unrated position, thus providing full credit support for the term of the unrated position.

#### E. Section 615.5210(e)—Low-Level Exposure Rule

New section 615.5210(e) limits the maximum risk-based capital requirement to the lesser of the maximum contractual exposure or the full capital charge against the outstanding amount of assets transferred with recourse. When the low-level exposure rule applies, an institution will generally hold capital dollar-for-dollar against the amount of its maximum contractual exposure. Thus, if

the maximum contractual exposure to loss retained or assumed in connection with recourse obligation or a direct credit substitute is less than the full risk-based capital requirement for the assets enhanced, the risk-based capital requirement is limited to the maximum contractual exposure.

In the absence of any other recourse provisions, the on-balance sheet amount of assets retained or assumed in connection with a recourse obligation or direct credit substitute represents the maximum contractual exposure. For example, assume that \$100 million in loans are sold and an FCS institution provides a \$5 million credit enhancement through a recourse obligation. Instead of holding 7 percent or \$7 million of capital, the low-level exposure limits the risk-based requirement to the \$5 million maximum contractual loss exposure, with \$5 million held dollar-for-dollar against capital.

#### F. Section 615.5211—Risk Categories—Balance Sheet Assets

##### 1. Section 615.5211(b)(6)—Securities and Other Claims on, and Portions of Claims Guaranteed by, Government-Sponsored Agencies

Under new § 615.5211(b)(6), securities and other claims on, and portions of claims guaranteed by, Government-sponsored agencies are assigned to the 20-percent risk-weight category. This category includes, for example, debt securities and asset- or mortgage-backed securities<sup>41</sup> guaranteed by Government-sponsored agencies. The category also includes assets covered by credit protection provided by Government-sponsored agencies through credit derivatives (e.g., credit default swaps), loss purchase commitments, guarantees, and other similar arrangements.

##### 2. Section 615.5211(a)(5), (b)(14), and (b)(15)—Treatment of Claims on Qualifying Securities Firms

We are adding claims on qualifying securities firms to the current risk-based capital requirements.<sup>42</sup>

Specifically, we are adopting a 0-percent risk weight for claims on, or guaranteed by, qualifying securities firms that are collateralized by cash held

<sup>41</sup> Stripped mortgage-backed securities, as discussed above, are assigned to the 100-percent risk-weighting category.

<sup>42</sup> Under revised § 615.201, “qualifying securities firm” means: (1) A securities firm incorporated in the United States that is a broker-dealer that is registered with the SEC and that complies with the SEC’s net capital regulations; and (2) a securities firm incorporated in any other OECD-based country, if the institution is subject to supervision and regulation comparable to that imposed on depository institutions in OECD countries.

<sup>40</sup> As indicated previously, credit-enhancing positions in securitizations are subject to dollar-for-dollar capital treatment.

<sup>39</sup> See new § 615.5210(e).

by the institution or by securities issued or guaranteed by the United States or OECD central governments, provided that a positive margin of collateral is required to be maintained on such a claim on a daily basis, taking into account any change in the institution's exposure to the obligor or counterparty under the claim in relation to the market value of the collateral held in support of the claim.<sup>43</sup>

We are also reducing from 100 percent to 20 percent the risk weighting applied to all other claims on and claims guaranteed by qualifying securities firms that satisfy specified external rating requirements.<sup>44</sup> Specifically, we are adopting a 20-percent risk weighting for all claims on and claims guaranteed by a qualifying securities firm that has a long-term issuer credit rating in one of the two highest investment-grade rating categories from an NRSRO, or if the claim is guaranteed by the qualifying securities firm's parent company with such a rating.<sup>45</sup>

Finally, we adopt a 20-percent risk weight for certain collateralized claims on qualifying securities firms without regard to satisfaction of the rating standard, provided the claim arises under a contract that:

- Is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed under standard industry documentation;
- Is collateralized by liquid and readily marketable debt or equity securities;
- Is marked-to-market daily;
- Is subject to a daily margin maintenance requirement under the standard documentation; and
- Can be liquidated, terminated, or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or voided, under applicable law of the relevant country.<sup>46</sup>

### 3. Section 615.5211(c)(2)—Treatment of Qualified Residential Loans

Existing § 613.3030 authorizes System institutions to provide financing to rural homeowners for the purpose of buying, remodeling, improving, and repairing rural homes. "Rural homeowner" is defined as an individual who resides in a rural area and is not a bona fide farmer, rancher, or producer or harvester of aquatic products. "Rural home" means a single-family

moderately priced dwelling located in a rural area that will be owned and occupied as the rural homeowner's principal residence. "Rural area" means open country within a state or the Commonwealth of Puerto Rico, which may include a town or village that has a population of not more than 2,500 persons.

Previous § 615.5210(f)(2)(iii)(B) assigned these rural home loans, provided they were secured by first lien mortgages or deeds of trust, to the 50-percent risk-weight category.<sup>47</sup> However, residential loans to bona fide farmers, ranchers, and producers and harvesters of aquatic products have formerly been considered to be agricultural loans and have been risk weighted at 100 percent under previous § 615.5210(f)(2)(iv).

New § 615.5211(c)(2) assigns a 50-percent risk weight to all qualified residential loans, as defined in revised § 615.5201. To be a qualified residential loan, a loan must be either: (i) A rural home loan, as authorized by § 613.3030,<sup>48</sup> or (ii) a single-family residential loan to a bona fide farmer, rancher, or producer or harvester of aquatic products.<sup>49</sup> A qualified residential loan must be secured by a first lien mortgage or deed of trust on the residential property only (not on any adjoining agricultural property or any other nonresidential property), must have been approved in accordance with prudent underwriting standards, must not be past due 90 days or more or carried in nonaccrual status, and must have a monthly amortization schedule. In addition, the mortgage or deed of trust securing the residential property must be written and recorded in accordance with all state and local requirements governing its enforceability as a first lien. Finally, the secured residential property must have a permanent right-of-way access.

The reason we are providing for a 50-percent risk weighting for residential loans to farmers, ranchers, and aquatic producers and harvesters that meet the standards set forth in the definition of qualified residential loan is because the risk weighting is commensurate with the level of risk, which is similar to the level of risk posed by residential loans to non-farmers that meet the same standards. Such residential loans generally carry lower risk than do loans secured by agricultural property.

This view is consistent with that of the other financial regulatory agencies. Under their rules, a loan that is fully secured by a first lien on a one- to four-family residential property is assigned to the 50-percent risk-weight category as long as the loan has been approved in accordance with prudent underwriting standards and is not past due 90 days or more or carried in nonaccrual status.<sup>50</sup> The other financial regulatory agencies do not distinguish among types of borrowers.

Consistent with the position of the other financial regulatory agencies, any residential loan that does not meet the definition of a qualified residential loan must be assigned to the 100-percent risk-weight category.

The other financial regulatory agencies have issued guidance that addresses their concerns about the appropriate risk weighting for residential loans with high loan-to-value (LTV) ratios. Unlike the lenders that these other agencies regulate, however, System institutions are limited by statute, except in limited circumstances, to an 85-percent LTV ratio on real estate (including residential real estate).<sup>51</sup> Therefore, this regulation does not contain specific LTV requirements. Assigning risk weighting based on specific risk factors with greater granularity (including LTV) is consistent with the underlying framework of Basel II. We expect to review these risk factors as we consider future rulemakings regarding Basel II.

We made one non-substantive change to the final rule. We added language to clarify that the first lien mortgage or deed of trust must be on the residential property only, not on any other property.<sup>52</sup>

The Farm Credit Council and six System institutions commented on this proposal. All commenters appreciated FCA's proposed reduction of the risk weighting for residential loans to farmers. Six of the seven commenters, however, stated that the proposed rule's requirement for a separate residential deed would be burdensome for the institution and costly for the borrower and that a separate survey or legal description could be used instead. One commenter stated that competitors make loans on residential property using legal descriptions but not recorded deeds and that the deed requirement is an additional cost and time requirement that would prevent it from competing

<sup>47</sup> This risk weighting has been retained in the new rule. See §§ 615.5201 and 615.5211(c)(2).

<sup>48</sup> As discussed above, these loans have previously been included in the 50-percent risk-weight category.

<sup>49</sup> As discussed above, these loans have previously received a 100-percent risk weighting.

<sup>50</sup> See, e.g., FDIC regulations at 12 CFR Part 325, Appendix A, II.C., Category 3.

<sup>51</sup> Section 1.10 of the Act.

<sup>52</sup> This requirement does not preclude an institution, in an abundance of caution, from taking other property as additional collateral.

<sup>43</sup> Proposed § 615.5211(a)(5).

<sup>44</sup> Proposed § 615.5211(b)(15).

<sup>45</sup> If ratings are available from more than one NRSRO, the lowest rating will be used to determine whether the rating standard has been met.

<sup>46</sup> See new § 615.5211(b)(16).

for these loans. Another commenter stated that the requirement for a separate residential deed penalizes farmers who own existing sites that were acquired as part of larger parcels from obtaining loans with 50-percent risk weighting to remodel or repair their homes. All of these commenters requested that we delete the requirement for a separate deed. Another commenter suggested, if the deed requirement could not be eliminated, that the regulation set a maximum acreage limitation, such as 50 or 100 acres, that could be included in the residential site.

In response to these comments, we have deleted the proposed rule's requirement that, for a residential loan to receive a 50-percent risk weighting, the secured residential property have a separate deed. We recognize that some states and localities may permit a lender to record and enforce a valid mortgage or deed of trust on property that is part of a larger deed, as long as the mortgage or deed of trust is written and recorded in accordance with all applicable requirements governing its enforceability as a first lien. Other states or localities, however, require that the mortgage or deed of trust may be recorded or enforced only if its property description is identical to that contained in the deed.

The final regulation, therefore, provides that, for a residential loan to receive a 50-percent risk weighting, the mortgage or deed of trust securing the residential property must be written and recorded in accordance with all state and local requirements governing its enforceability as a first lien. In those states or localities where the description of property in the deed must match the description in the mortgage or deed of trust, the deed must cover the residential property only. In those states or localities where the description of property in the deed need not match the description in the mortgage or deed of trust, a separate deed on the residential property only is not required. In all situations, to receive the 50-percent risk weighting, institutions must follow state and local recordation requirements governing enforceability of the mortgage or deed of trust as a first lien.

Using risk-based examination principles, FCA examiners will review these loans as part of their examination process to determine whether they have been categorized appropriately. As part of this review, the examiners will review the institution's underwriting standards for qualified residential loans and appropriate application of those standards. Their review will focus on ensuring the underwriting standards

contain appropriate criteria, including that a loan is secured by a first lien on residential property alone (not on any adjoining agricultural property or any other nonresidential property).

The examiners may also review other factors that indicate whether the loan is a bona fide residential mortgage loan. The factors may include, but are not limited to:

- The marketability of the property as residential property with a marketable dwelling;
- The zoning and planning requirements that enable the property to be marketable as a residential property; and
- Whether the characteristics and market value of the property are commensurate with those of residential properties in the local market area.

We chose not to set a specific acreage limitation because size does not necessarily determine the residential nature of property. Rather, we expect each institution to adopt underwriting standards that would ensure the collateral is characteristic of comparable residential property. If FCA examiners find that the collateral is not characteristic of residential property or that any loan was inappropriately classified as a qualified residential loan, the Agency will require the loan to be risk weighted at 100 percent.

#### 4. Section 615.5211(d)(8)—Treatment of Investments in Rural Business Investment Companies

As previously discussed, the Farm Security and Rural Investment Act (Pub. L. 107–171) amended the Consolidated Farm and Rural Development Act, 7 U.S.C. 1921 *et seq.*, to permit FCS institutions to establish or invest in RBICs subject to certain limitations. A RBIC has a similar mission and objectives to serve rural entrepreneurs as a Small Business Investment Company (SBIC) does to serve qualifying small businesses. Currently, the other financial regulatory agencies risk weight investments in SBICs at 100 percent and deduct from capital an escalating percentage of SBIC investments that exceed 15 percent of capital.<sup>53</sup> In this rule, FCA risk weights investments in RBICs at 100 percent.<sup>54</sup> FCA is not limiting the amount of RBIC investments that can receive the 100-percent risk weight because a System institution is precluded by statute from making an investment in a RBIC in excess of 5 percent of the capital and surplus of the institution.<sup>55</sup> This

statutory limitation imposes adequate controls on risk from these investments.

#### G. Section 615.5212(b)(4)(i)—Computation of Credit-Equivalent Amounts for Direct Credit Substitutes and Recourse Obligations

The final rule modifies our methodology for determining the credit equivalent amount of off-balance sheet direct credit substitutes and adds a similar provision for recourse obligations. Under the new rule, the credit equivalent amount for a direct credit substitute or recourse obligation is the full amount of the credit-enhanced assets for which an institution directly or indirectly retains or assumes credit risk multiplied by a 100-percent conversion factor.<sup>56</sup> To determine the institution's risk-weighted assets for an off-balance sheet recourse obligation or a direct credit substitute, the credit equivalent amount is assigned to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral.

The rule eliminates the previous anomalies between direct credit substitutes and recourse arrangements that expose an institution to the same amount of risk but had different capital requirements. These changes will also provide consistent risk-based capital treatment for positions with similar risk exposures regardless of whether they are structured as on-or off-balance sheet transactions. For example, as noted previously, for a direct credit substitute that is an on-balance sheet asset, *e.g.*, a purchased subordinated security, an institution must also calculate risk-weighted assets using the amount of the direct credit substitute and the full amount of the assets it supports, meaning all the more senior positions in the structure. This is another change necessary to make our rules consistent with the current rules established by the other financial regulatory agencies.

#### H. Section 615.5210(f)—Reservation of Authority

Financial institutions are developing novel transactions that do not fit into the conventional risk-weight categories or credit conversion factors in the current standards. Financial institutions are also devising novel instruments that nominally fit into a particular category but impose levels of risk on the financial institutions that are not commensurate with the risk-weight category for the asset, exposure, or instrument. Accordingly, new § 615.5210(f) of the rule more explicitly

<sup>53</sup> See 67 FR 3784, January 25, 2002.

<sup>54</sup> See new § 615.5211(d)(8).

<sup>55</sup> 7 U.S.C. 2009cc–9(b).

<sup>56</sup> See new § 615.5212(b)(4)(i).

indicates that FCA, on a case-by-case basis, may determine the appropriate risk weight for any asset or credit equivalent amount and the appropriate credit conversion factor for any off-balance sheet item in these circumstances. Exercise of this authority may result in a higher or lower risk weight or credit equivalent amount for these assets or off-balance sheet items. This reservation of authority explicitly recognizes the retention of sufficient discretion to ensure that novel financial assets, exposures, and instruments will be treated appropriately under the regulatory capital standards.

## VI. Other Changes

In addition to the changes detailed above, we also make a number of other changes. We make most of these changes for clarity or plain language purposes or to eliminate obsolete references. These changes are described below.

### A. Section 615.5211—Changes to Listing of Balance Sheet Assets

We clarify the listing of balance sheet assets identified in each risk-weight category in new § 615.5211 to more closely align the regulatory language with our long-standing policy positions. This new regulatory language also mirrors the language used by the other financial regulatory agencies to the extent applicable to System institutions. Over the years, we have generally interpreted our risk-weighting categories consistently with the other financial regulatory agencies. In some instances, however, the listing of assets included in each category is not as specific or clear as that of the other financial regulatory agencies. We make these amendments for the purpose of clarity and consistency with the other financial regulatory agencies.

#### 1. Section 615.5211(a)—0-Percent Category

We have reorganized the order of the assets listed in the 0-percent risk-weight category.<sup>57</sup> We have added a listing for portions of local currency claims on, or unconditionally guaranteed by, non-OECD central governments (including non-OECD central banks), to the extent the institution has liabilities booked in that currency (§ 615.5211(a)(4)). We have also revised the language in § 615.5211(a)(1), (a)(2), and (a)(3).<sup>58</sup> Finally, we have deleted previous § 615.5210(f)(2)(i)(C), which put goodwill in the 0-percent category. New

<sup>57</sup> Except where otherwise indicated, all references are to the new regulation.

<sup>58</sup> See previous § 615.5210(f)(2)(i)(A), (f)(2)(i)(B), and (f)(2)(i)(C).

§ 615.5207(g) (which carried over without substantive change from previous § 615.5210(e)(7)) provides that an institution must deduct from total capital an amount equal to all goodwill before it assigns assets to the risk-weighting categories. Thus, it is unnecessary to assign goodwill to a risk-weighting category.

#### 2. Section 615.5211(b)—20-Percent Category

We have reorganized the order of the assets listed in the 20-percent risk-weight category.<sup>59</sup> We have added the following assets in addition to the changes previously discussed:

- Portions of loans and other claims collateralized by cash on deposit (§ 615.5211(b)(8));
- Portions of claims collateralized by securities issued by official multinational lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member (§ 615.5211(b)(11)); and
- Investments in shares of mutual funds whose portfolios are permitted to hold only assets that qualify for the zero or 20-percent risk-weight categories (§ 615.5211(b)(12)).

We have revised the language in § 615.5211(b)(3),<sup>60</sup> (b)(4),<sup>61</sup> (b)(5),<sup>62</sup> (b)(7),<sup>63</sup> (b)(9),<sup>64</sup> and (b)(10)<sup>65</sup> to make these provisions easier to read. In addition, we added the language in § 615.5211(b)(6) to clarify our policy position and to conform to the language used by for the other financial regulatory agencies.

#### 3. Section 615.5211(c)—50-Percent Category

In the 50-percent risk-weight category, we added a listing for revenue bonds or similar obligations, including loans and leases, that are obligations of a state or political subdivisions of the United States or other OECD countries but for which the government entity is committed to repay the debt only out of revenue from the specific projects financed.<sup>66</sup> We are making these revisions to further distinguish the varying degrees of risk associated with investments in different types of

<sup>59</sup> Except where otherwise indicated, all references are to the new regulation.

<sup>60</sup> Consolidated from previous § 615.5210(f)(2)(ii)(D) and (f)(2)(ii)(E).

<sup>61</sup> Previous § 615.5210(f)(2)(ii)(F).

<sup>62</sup> Consolidated from previous § 615.4210(f)(2)(ii)(B) and (f)(2)(ii)(F).

<sup>63</sup> Consolidated from previous § 615.5210(f)(2)(ii)(A) and (f)(2)(ii)(C).

<sup>64</sup> See previous § 615.5210(f)(2)(ii)(G).

<sup>65</sup> See previous § 615.5210(f)(2)(ii)(H).

<sup>66</sup> New § 615.5211(c)(4). This provision was not contained in previous FCA regulations.

revenue bonds. This change also parallels the rules of the other financial regulatory agencies. We also made plain language changes to § 615.5211(c)(1).<sup>67</sup>

#### 4. Section 615.5211(d)—100-Percent Category

The previous 100-percent risk-weight category listed only four assets, including a catch-all: All other assets not specified in the other risk-weight categories, including, but not limited to, leases, fixed assets, and receivables. Consistent with the other financial regulatory agencies, and to provide clearer guidance, we have itemized many of the assets that were previously included within the catch-all, including:

- Claims on, or portions of claims guaranteed by, non-OECD central governments (except such claims that are included in other risk-weighting categories), and all claims on non-OECD state and local governments (§ 615.5211(d)(3));
- Industrial development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest (§ 615.5211(d)(4));
- Premises, plant, and equipment; other fixed assets; and other real estate owned (§ 615.5211(d)(5));
- If they have not already been deducted from capital, investments in unconsolidated companies, joint ventures, or associated companies; deferred-tax assets; and servicing assets (§ 615.5211(d)(9)); and
- All other assets not specified, including, but not limited to, leases and receivables (§ 615.5211(d)(12)).

### B. Other Nonsubstantive Changes

We have changed the heading of § 615.5200 from “General” to “Capital planning” to better reflect the content of this section. We have made no other changes to this section.

We have broken up previous § 615.5210, which was cumbersome to use because of its length, into seven separate regulatory sections. The newly redesignated sections are:

- § 615.5206—Permanent capital ratio computation.
- § 615.5207—Capital adjustments and associated reductions to assets.
- § 615.5208—Allotment of allocated investments.
- § 615.5209—Deferred-tax assets.
- § 615.5210—Risk-adjusted assets.
- § 615.5211—Risk categories—balance sheet assets.

<sup>67</sup> See previous § 615.5210(f)(2)(iii)(A).

- § 615.5212—Credit conversion factors—off-balance sheet items.

This reorganization should make these provisions easier to use. We do not intend to make any substantive changes with this reorganization.

We have deleted an obsolete reference to the Farm Credit System Financial Assistance Corporation in § 615.5201.

We have added paragraph (k) to newly redesignated § 615.5207 for clarity.

We have made minor, nonsubstantive, plain language, and organizational changes throughout the revised regulation.

Because we have reorganized this regulation, references to the regulation in other FCA regulations need to be updated. Accordingly, we have made conforming reference updates in parts 607, 614, and 620 of this chapter.

## VII. 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 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.

### List of Subjects

#### 12 CFR Part 607

Accounting, Agriculture, Banks, banking, Reporting and recordkeeping requirements, Rural areas.

#### 12 CFR Part 614

Agriculture, Banks, banking, Flood insurance, Foreign trade, Reporting and recordkeeping requirements, Rural areas.

#### 12 CFR Part 615

Accounting, Agriculture, Banks, banking, Government securities, Investments, Rural areas.

#### 12 CFR Part 620

Accounting, Agriculture, Banks, banking, Reporting and recordkeeping requirements, Rural areas.

- For the reasons stated in the preamble, we amend parts 607, 614, 615, and 620 of chapter VI, title 12 of the Code of Federal Regulations as follows:

### PART 607—ASSESSMENT AND APPORTIONMENT OF ADMINISTRATIVE EXPENSES

- 1. The authority citation for part 607 continues to read as follows:

**Authority:** Secs. 5.15, 5.17 of the Farm Credit Act (12 U.S.C. 2250, 2252) and 12 U.S.C. 3025.

#### § 607.2 [Amended]

- 2. Amend § 607.2(b) introductory text by removing the reference “§ 615.5210(f)” and adding in its place “§ 615.5210.”

### PART 614—LOAN POLICIES AND OPERATIONS

- 3. 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

- 4. Revise § 614.4351 (a) introductory text to read as follows:

#### § 614.4351 Computation of lending and leasing limit base

(a) *Lending and leasing limit base.* An institution’s lending and leasing limit base is composed of the permanent capital of the institution, as defined in § 615.5201 of this chapter, with adjustments applicable to the institution provided for in § 615.5207 of this chapter, and with the following further adjustments:

\* \* \* \* \*

### PART 615—FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS, AND FUNDING OPERATIONS

- 5. The authority citation for part 615 continues 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.

### Subpart H—Capital Adequacy

- 6. Revise the heading of § 615.5200 to read as follows:

#### § 615.5200 Capital planning.

\* \* \* \* \*

- 7. Revise § 615.5201 to read as follows:

#### § 615.5201 Definitions.

For the purpose of this subpart, the following definitions apply:

*Allocated investment* means earnings allocated but not paid in cash by a System bank to an association or other recipient.

*Bank* means an institution that:

- (1) Engages in the business of banking;
- (2) Is recognized as a bank by the bank supervisory or monetary authority of the country of its organization or principal banking operations;
- (3) Receives deposits to a substantial extent in the regular course of business; and
- (4) Has the power to accept demand deposits.

*Commitment* means any arrangement that legally obligates an institution to:

- (1) Purchase loans or securities;
- (2) Participate in loans or leases;
- (3) Extend credit in the form of loans or leases;
- (4) Pay the obligation of another;
- (5) Provide overdraft, revolving credit, or underwriting facilities; or
- (6) Participate in similar transactions.

*Credit conversion factor* means that number by which an off-balance sheet item is multiplied to obtain a credit equivalent before placing the item in a risk-weight category.

*Credit derivative* means a contract that allows one party (the protection purchaser) to transfer the credit risk of an asset or off-balance sheet credit exposure to another party (the protection provider). The value of a credit derivative is dependent, at least in part, on the credit performance of a “reference asset.”

*Credit-enhancing interest-only strip*—

- (1) The term credit-enhancing interest-only strip means an on-balance sheet asset that, in form or in substance:
  - (i) Represents the contractual right to receive some or all of the interest due on transferred assets; and
  - (ii) Exposes the institution to credit risk directly or indirectly associated with the transferred assets that exceeds its pro rata claim on the assets, whether through subordination provisions or other credit enhancement techniques.

- (2) FCA reserves the right to identify other cash flows or related interests as credit-enhancing interest-only strips. In determining whether a particular

interest cash flow functions as a credit-enhancing interest-only strip, FCA will consider the economic substance of the transaction.

Credit-enhancing representations and warranties—

(1) The term credit-enhancing representations and warranties means representations and warranties that:

(i) Are made or assumed in connection with a transfer of assets (including loan-servicing assets), and

(ii) Obligate an institution to protect investors from losses arising from credit risk in the assets transferred or loans serviced.

(2) Credit-enhancing representations and warranties include promises to protect a party from losses resulting from the default or nonperformance of another party or from an insufficiency in the value of the collateral.

(3) Credit-enhancing representations and warranties do not include:

(i) Early-default clauses and similar warranties that permit the return of, or premium refund clauses covering, loans for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of the transfer;

(ii) Premium refund clauses covering assets guaranteed, in whole or in part, by the United States Government, a United States Government agency, or a United States Government-sponsored agency, provided the premium refund clause is for a period not to exceed 120 days from the date of transfer;

(iii) Warranties that permit the return of assets in instances of fraud, misrepresentation, or incomplete documentation; or

(iv) Clean-up calls if the agreements to repurchase are limited to 10 percent or less of the original pool balance (except where loans 30 days or more past due are repurchased).

*Deferred-tax assets that are dependent on future income or future events* means:

(1) Deferred-tax assets arising from deductible temporary differences dependent upon future income that exceed the amount of taxes previously paid that could be recovered through loss carrybacks if existing temporary differences (both deductible and taxable and regardless of where the related tax-deferred effects are recorded on the institution's balance sheet) fully reverse;

(2) Deferred-tax assets dependent upon future income arising from operating loss and tax carryforwards;

(3) Deferred-tax assets arising from temporary differences that could be recovered if existing temporary differences that are dependent upon

other future events (both deductible and taxable and regardless of where the related tax-deferred effects are recorded on the institution's balance sheet) fully reverse.

*Direct credit substitute* means an arrangement in which an institution assumes, in form or in substance, credit risk directly or indirectly associated with an on-or off-balance sheet asset or exposure that was not previously owned by the institution (third-party asset) and the risk assumed by the institution exceeds the pro rata share of the institution's interest in the third-party asset. If the institution has no claim on the third-party asset, then the institution's assumption of any credit risk is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(1) Financial standby letters of credit that support financial claims on a third party that exceed an institution's pro rata share in the financial claim;

(2) Guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed an institution's pro rata share in the financial claim;

(3) Purchased subordinated interests that absorb more than their pro rata share of losses from the underlying assets;

(4) Credit derivative contracts under which the institution assumes more than its pro rata share of credit risk on a third-party asset or exposure;

(5) Loans or lines of credit that provide credit enhancement for the financial obligations of a third party;

(6) Purchased loan-servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Servicer cash advances as defined in this section are not direct credit substitutes; and,

(7) Clean-up calls on third-party assets. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the institution are not direct credit substitutes.

*Direct lender institution* means an institution that extends credit in the form of loans or leases to eligible borrowers in its own right and carries such loan or lease assets on its books.

*Externally rated* means that an instrument or obligation has received a credit rating from at least one NRSRO.

*Face amount* means:

(1) The notional principal, or face value, amount of an off-balance sheet item;

(2) The amortized cost of an asset not held for trading purposes; and

(3) The fair value of a trading asset.

*Financial asset* means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive from or exchange cash or another financial instrument with another party.

*Financial standby letter of credit* means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

(1) To repay money borrowed by, or advanced to, or for the account of, a second party (the account party); or

(2) To make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

*Government agency* means an agency or instrumentality of the United States Government whose obligations are fully and explicitly 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 guaranteed by the full faith and credit of the United States Government, including but not limited to any Government-sponsored enterprise.

*Institution* means a Farm Credit Bank, Federal land bank association, Federal land credit association, production credit association, agricultural credit association, Farm Credit Leasing Services Corporation, bank for cooperatives, agricultural credit bank, and their successors.

*Nationally recognized statistical rating organization (NRSRO)* means a rating organization that the Securities and Exchange Commission recognizes as an NRSRO.

*Non-OECD bank* means a bank and its branches (foreign and domestic) organized under the laws of a country that does not belong to the OECD group of countries.

*Nonagreeing association* means an association that does not have an allotment agreement in effect with a Farm Credit Bank or agricultural credit bank pursuant to § 615.5207(b)(2).

*OECD* means the group of countries that are full members of the Organization for Economic Cooperation and Development, regardless of entry date, as well as countries that have concluded special lending arrangements with the International Monetary Fund's General Arrangement to Borrow, excluding any country that has

rescheduled its external sovereign debt within the previous 5 years.

*OECD bank* means a bank and its branches (foreign and domestic) organized under the laws of a country that belongs to the OECD group of countries. For purposes of this subpart, this term includes U.S. depository institutions.

*Performance-based standby letter of credit* means any letter of credit, or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer to make payment as a result of any default by a third party in the performance of a nonfinancial or commercial obligation.

*Permanent capital*, subject to adjustments as described in § 615.5207, includes:

(1) Current year retained earnings;  
 (2) Allocated and unallocated earnings (which, in the case of earnings allocated in any form by a System bank to any association or other recipient and retained by the bank, must be considered, in whole or in part, permanent capital of the bank or of any such association or other recipient as provided under an agreement between the bank and each such association or other recipient);

(3) All surplus;

(4) Stock issued by a System institution, except:

(i) 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;

(ii) Stock that is protected under section 4.9A of the Act or is otherwise not at risk;

(iii) Farm Credit Bank equities required to be purchased by Federal land bank associations in connection with stock issued to borrowers that is protected under section 4.9A of the Act;

(iv) Capital subject to revolvment, unless:

(A) The bylaws of the institution clearly provide that there is no express or implied right for such capital to be retired at the end of the revolvment cycle or at any other time; and

(B) The institution clearly states in the notice of allocation that such capital may only be retired 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 revolvment cycle or at any other time is thereby granted;

(5) Term preferred stock with an original maturity 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);

(6) Financial assistance provided by the Farm Credit System Insurance Corporation that the FCA determines appropriate to be considered permanent capital; and

(7) Any other debt or equity instruments or other accounts the FCA has determined are appropriate to be considered permanent capital. The FCA may permit one or more institutions to include all or a portion of such instrument, entry, or account as permanent capital, permanently or on a temporary basis, for purposes of this part.

*Qualified residential loan*—

(1) The term qualified residential loan means:

(i) A rural home loan, as authorized by § 613.3030, and

(ii) A single-family residential loan to a bona fide farmer, rancher, or producer or harvester of aquatic products.

(2) A qualified residential loan must be secured by a separate first lien mortgage or deed of trust on the residential property alone (not on any adjoining agricultural property or any other nonresidential property), must have been approved in accordance with prudent underwriting standards suitable for residential property, must not be past due 90 days or more or carried in nonaccrual status, and must have a monthly amortization schedule. In addition, the mortgage or deed of trust securing the residential property must be written and recorded in accordance with all state and local requirements governing its enforceability as a first lien and the secured residential property must have a permanent right-of-way access.

*Qualifying bilateral netting contract* means a bilateral netting contract that meets at least the following conditions:

(1) The contract is in writing;

(2) The contract is not subject to a walkaway clause, defined as a provision that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract;

(3) The contract creates a single obligation either to pay or receive the net amount of the sum of positive and negative mark-to-market values for all

derivative contracts subject to the qualifying bilateral netting contract;

(4) The institution receives a legal opinion that represents, to a high degree of certainty, that in the event of legal challenge the relevant court and administrative authorities would find the institution's exposure to be the net amount;

(5) The institution establishes a procedure to monitor relevant law and to ensure that the contracts continue to satisfy the requirements of this section; and

(6) The institution maintains in its files adequate documentation to support the netting of a derivatives contract.

*Qualifying securities firm* means:

(1) A securities firm incorporated in the United States that is a broker-dealer that is registered with the Securities and Exchange Commission (SEC) and that complies with the SEC's net capital regulations (17 CFR 240.15c3-1); and

(2) A securities firm incorporated in any other OECD-based country, if the institution is able to demonstrate that the securities firm is subject to supervision and regulation (covering its direct and indirect subsidiaries, but not necessarily its parent organizations) comparable to that imposed on depository institutions in OECD countries. Such regulation must include risk-based capital requirements comparable to those imposed on depository institutions under the Accord on International Convergence of Capital Measurement and Capital Standards (1988, as amended in 1998) (Basel Accord).

*Recourse* means an institution's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold (in accordance with GAAP) that exceeds a pro rata share of the institution's claim on the asset. If an institution has no claim on an asset it has sold, then the retention of any credit risk is recourse. A recourse obligation typically arises when an institution transfers assets in a sale and retains an explicit obligation to repurchase assets or to absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if an institution provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include, but are not limited to:

(1) Credit-enhancing representations and warranties made on transferred assets;

(2) Loan-servicing assets retained pursuant to an agreement under which the institution will be responsible for



losses associated with the loans serviced. Servicer cash advances as defined in this section are not recourse obligations;

(3) Retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets;

(4) Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;

(5) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;

(6) Credit derivatives issued that absorb more than the institution's pro rata share of losses from the transferred assets; and

(7) Clean-up call on assets the institution has sold. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the institution are not recourse arrangements.

Residual interest—

(1) The term residual interest means any on-balance sheet asset that:

(i) Represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise; and

(ii) Exposes an institution to credit risk directly or indirectly associated with the transferred asset that exceeds a pro rata share of the institution's claim on the asset, whether through subordination provisions or other credit enhancement techniques.

(2) Residual interests generally include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests (and other forms of overcollateralization), and similar assets that function as a credit enhancement.

(3) Residual interests further include those exposures that, in substance, cause the institution to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold.

(4) Residual interests generally do not include interests purchased from a third party. However, purchased credit-enhancing interest-only strips are residual interests.

*Risk-adjusted asset base* means the total dollar amount of the institution's assets adjusted in accordance with § 615.5207 and weighted on the basis of risk in accordance with §§ 615.5211 and 615.5212.

*Risk participation* means a participation in which the originating party remains liable to the beneficiary for the full amount of an obligation (e.g., a direct credit substitute) notwithstanding that another party has acquired a participation in that obligation.

*Rural Business Investment Company* has the definition given in 7 U.S.C. 2009cc(14).

*Securitization* means the pooling and repackaging by a special purpose entity or trust of assets or other credit exposures that can be sold to investors. Securitization includes transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

*Servicer cash advance* means funds that a mortgage servicer advances to ensure an uninterrupted flow of payments, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the loan. A servicer cash advance is not a recourse obligation or a direct credit substitute if:

(1) The servicer is entitled to full reimbursement and this right is not subordinated to other claims on the cash flows from the underlying asset pool; or

(2) For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal amount on that loan.

*Stock* means stock and participation certificates.

*Total capital* means assets minus liabilities, valued in accordance with generally accepted accounting principles, except that liabilities do not include obligations to retire stock protected under section 4.9A of the Act.

*Traded position* means a position retained, assumed, or issued that is externally rated, where there is a reasonable expectation that, in the near future, the rating will be relied upon by:

(1) Unaffiliated investors to purchase the position; or

(2) An unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan, or repurchase agreement.

*U.S. depository institution* means branches (foreign and domestic) of federally insured banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and United States territories and possessions. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions,

international banking facilities of domestic depository institutions, and U.S.-chartered depository institutions owned by foreigners. The definition excludes branches and agencies of foreign banks located in the U.S. and bank holding companies.

#### § 615.5210 [Removed]

■ 8. Remove existing § 615.5210.

■ 9. Add new §§ 615.5206 through 615.5212 to read as follows:

#### § 615.5206 Permanent capital ratio computation.

(a) The institution's permanent capital ratio is determined on the basis of the financial statements of the institution prepared in accordance with generally accepted accounting principles except that the obligations of the Farm Credit System Financial Assistance Corporation issued to repay banks in connection with the capital preservation and loss-sharing agreements described in section 6.9(e)(1) of the Act shall not be considered obligations of any institution subject to this regulation prior to their maturity.

(b) The institution's asset base and permanent capital are computed using average daily balances for the most recent 3 months.

(c) The institution's permanent capital ratio is calculated by dividing the institution's permanent capital, adjusted in accordance with § 615.5207 (the numerator), by the risk-adjusted asset base (the denominator) as determined in § 615.5210, to derive a ratio expressed as a percentage.

(d) Until September 27, 2002, payments of assessments to the Farm Credit System Financial Assistance Corporation, and any part of the obligation to pay future assessments to the Farm Credit System Financial Assistance Corporation that is recognized as an expense on the books of a bank or association, shall be included in the capital of such bank or association for the purpose of determining its compliance with regulatory capital requirements, to the extent allowed by section 6.26(c)(5)(G) of the Act. If the bank directly or indirectly passes on all or part of the payments to its affiliated associations pursuant to section 6.26(c)(5)(D) of the Act, such amounts shall be included in the capital of the associations and shall not be included in the capital of the bank. After September 27, 2002, no payments of assessments or obligations to pay future assessments may be included in the capital of the bank or association.

**§ 615.5207 Capital adjustments and associated reductions to assets.**

For the purpose of computing the institution's permanent capital ratio, the following adjustments must be made prior to assigning assets to risk-weight categories and computing the ratio:

(a) Where two Farm Credit System institutions have stock investments in each other, such reciprocal holdings must be eliminated to the extent of the offset. If the investments are equal in amount, each institution must deduct from its assets and its total capital an amount equal to the investment. If the investments are not equal in amount, each institution must deduct from its total capital and its assets an amount equal to the smaller investment. The elimination of reciprocal holdings required by this paragraph must be made prior to making the other adjustments required by this section.

(b) Where a Farm Credit Bank or an agricultural credit bank is owned by one or more Farm Credit System institutions, the double counting of capital is eliminated in the following manner:

(1) All equities of a Farm Credit Bank or agricultural credit bank that have been purchased by other Farm Credit institutions are considered to be permanent capital of the Farm Credit Bank or agricultural credit bank.

(2) Each Farm Credit Bank or agricultural credit bank and each of its affiliated associations may enter into an agreement that specifies, for the purpose of computing permanent capital only, a dollar amount and/or percentage allotment of the association's allocated investment between the bank and the association. Section 615.5208 provides conditions for allotment agreements or defines allotments in the absence of such agreements.

(c) A Farm Credit Bank or agricultural credit bank and a recipient, other than an association, of allocated earnings from such bank may enter into an agreement specifying a dollar amount and/or percentage allotment of the recipient's allocated earnings in the bank between the bank and the recipient. Such agreement must comply with the provisions of paragraph (b) of this section, except that, in the absence of an agreement, the allocated investment must be allotted 100 percent to the allocating bank and 0 percent to the recipient. All equities of the bank that are purchased by a recipient are considered as permanent capital of the issuing bank.

(d) A bank for cooperatives and a recipient of allocated earnings from such bank may enter into an agreement specifying a dollar amount and/or

percentage allotment of the recipient's allocated earnings in the bank between the bank and the recipient. Such agreement must comply with the provisions of paragraph (b) of this section, except that, in the absence of an agreement, the allocated investment must be allotted 100 percent to the allocating bank and 0 percent to the recipient. All equities of a bank that are purchased by a recipient shall be considered as permanent capital of the issuing bank.

(e) Where a bank or association invests in an association to capitalize a loan participation interest, the investing institution must deduct from its total capital an amount equal to its investment in the participating institution.

(f) The double counting of capital by a service corporation chartered under section 4.25 of the Act and its stockholder institutions must be eliminated by deducting an amount equal to the institution's investment in the service corporation from its total capital.

(g) Each institution must deduct from its total capital an amount equal to all goodwill, whenever acquired.

(h) To the extent an institution has deducted its investment in another Farm Credit institution from its total capital, the investment may be eliminated from its asset base.

(i) Where a Farm Credit Bank and an association have an enforceable written agreement to share losses on specifically identified assets on a predetermined quantifiable basis, such assets must be counted in each institution's risk-adjusted asset base in the same proportion as the institutions have agreed to share the loss.

(j) The permanent capital of an institution must exclude the net effect of all transactions covered by the definition of "accumulated other comprehensive income" contained in the Statement of Financial Accounting Standards No. 130, as promulgated by the Financial Accounting Standards Board.

(k) For purposes of calculating capital ratios under this part, deferred-tax assets are subject to the conditions, limitations, and restrictions described in § 615.5209.

(l) Capital may also need to be reduced for potential loss exposure on any recourse obligations, direct credit substitutes, residual interests, and credit-enhancing interest-only-strips in accordance with § 615.5210.

**§ 615.5208 Allotment of allocated investments.**

(a) The following conditions apply to agreements that a Farm Credit Bank or agricultural credit bank enters into with an affiliated association pursuant to § 615.5207(b)(2):

(1) The agreement must be for a term of 1 year or longer.

(2) The agreement must be entered into on or before its effective date.

(3) The agreement may be amended according to its terms, but no more frequently than annually except in the event that a party to the agreement is merged or reorganized.

(4) On or before the effective date of the agreement, a certified copy of the agreement, and any amendments thereto, must be sent to the field office of the Farm Credit Administration responsible for examining the institution. A copy must also be sent within 30 calendar days of adoption to the bank's other affiliated associations.

(5) Unless the parties otherwise agree, if the bank and the association have not entered into a new agreement on or before the expiration of an existing agreement, the existing agreement will automatically be extended for another 12 months, unless either party notifies the Farm Credit Administration in writing of its objection to the extension prior to the expiration of the existing agreement.

(b) In the absence of an agreement between a Farm Credit Bank or an agricultural credit bank and one or more associations, or in the event that an agreement expires and at least one party has timely objected to the continuation of the terms of its agreement, the following formula applies with respect to the allocated investments held by those associations with which there is no agreement (nonagreeing associations), and does not apply to the allocated investments held by those associations with which the bank has an agreement (agreeing associations):

(1) The allotment formula must be calculated annually.

(2) The permanent capital ratio of the Farm Credit Bank or agricultural credit bank must be computed as of the date that the existing agreement terminates, using a 3-month average daily balance, excluding the allocated investment from nonagreeing associations but including any allocated investments of agreeing associations that are allotted to the bank under applicable allocation agreements. The permanent capital ratio of each nonagreeing association must be computed as of the same date using a 3-month average daily balance, and must be computed excluding its allocated investment in the bank.

(3) If the permanent capital ratio for the Farm Credit Bank or agricultural credit bank calculated in accordance with § 615.5208(b)(2) is 7 percent or above, the allocated investment of each nonagreeing association whose permanent capital ratio calculated in accordance with § 615.5208(b)(2) is 7 percent or above must be allotted 50 percent to the bank and 50 percent to the association.

(4) If the permanent capital ratio of the Farm Credit Bank or agricultural credit bank calculated in accordance with § 615.5208(b)(2) is 7 percent or above, the allocated investment of each nonagreeing association whose capital ratio is below 7 percent must be allotted to the association until the association's capital ratio reaches 7 percent or until all of the investment is allotted to the association, whichever occurs first. Any remaining unallotted allocated investment must be allotted 50 percent to the bank and 50 percent to the association.

(5) If the permanent capital ratio of the Farm Credit Bank or agricultural credit bank calculated in accordance with § 615.5208(b)(2) is less than 7 percent, the amount of additional capital needed by the bank to reach a permanent capital ratio of 7 percent must be determined, and an amount of the allocated investment of each nonagreeing association must be allotted to the Farm Credit Bank or agricultural credit bank, as follows:

(i) If the total of the allocated investments of all nonagreeing associations is greater than the additional capital needed by the bank, the allocated investment of each nonagreeing association must be multiplied by a fraction whose numerator is the amount of capital needed by the bank and whose denominator is the total amount of allocated investments of the nonagreeing associations, and such amount must be allotted to the bank. Next, if the permanent capital ratio of any nonagreeing association is less than 7 percent, a sufficient amount of unallotted allocated investment must then be allotted to each nonagreeing association, as necessary, to increase its permanent capital ratio to 7 percent, or until all such remaining investment is allotted to the association, whichever occurs first. Any unallotted allocated investment still remaining must be allotted 50 percent to the bank and 50 percent to the nonagreeing association.

(ii) If the additional capital needed by the bank is greater than the total of the allocated investments of the nonagreeing associations, all of the remaining allocated investments of the

nonagreeing associations must be allotted to the bank.

(c) If a payment or part of a payment to the Farm Credit System Financial Assistance Corporation pursuant to section 6.9(e)(3)(D)(ii) of the Act would cause a bank to fall below its minimum permanent capital requirement, the bank and one or more associations shall amend their allocation agreements to increase the allotment of the allocated investment to the bank sufficiently to enable the bank to make the payment to the Farm Credit System Financial Assistance Corporation, provided that the associations would continue to meet their minimum permanent capital requirement. In the case of a nonagreeing association, the Farm Credit Administration may require a revision of the allotment sufficient to enable the bank to make the payment to the Farm Credit System Financial Assistance Corporation, provided that the association would continue to meet its minimum permanent capital requirement. The Farm Credit Administration may, at the request of one or more of the institutions affected, waive the requirements of this paragraph if the FCA deems it is in the overall best interest of the institutions affected.

#### § 615.5209 Deferred-tax assets.

For purposes of calculating capital ratios under this part, deferred-tax assets are subject to the conditions, limitations, and restrictions described in this section.

(a) Each institution must deduct an amount of deferred-tax assets, net of any valuation allowance, from its assets and its total capital that is equal to the greater of:

(1) The amount of deferred-tax assets that is dependent on future income or future events in excess of the amount that is reasonably expected to be realized within 1 year of the most recent calendar quarter-end date, based on financial projections for that year, or

(2) The amount of deferred-tax assets that is dependent on future income or future events in excess of 10 percent of the amount of core surplus that exists before the deduction of any deferred-tax assets.

(b) For purposes of this calculation:

(1) The amount of deferred-tax assets that can be realized from taxes paid in prior carryback years and from the reversal of existing taxable temporary differences may not be deducted from assets and from equity capital.

(2) All existing temporary differences should be assumed to fully reverse at the calculation date.

(3) Projected future taxable income should not include net operating loss carryforwards to be used within 1 year or the amount of existing temporary differences expected to reverse within that year.

(4) Financial projections must include the estimated effect of tax-planning strategies that are expected to be implemented to minimize tax liabilities and realize tax benefits. Financial projections for the current fiscal year (adjusted for any significant changes that have occurred or are expected to occur) may be used when applying the capital limit at an interim date within the fiscal year.

(5) The deferred tax effects of any unrealized holding gains and losses on available-for-sale debt securities may be excluded from the determination of the amount of deferred-tax assets that are dependent upon future taxable income and the calculation of the maximum allowable amount of such assets. If these deferred-tax effects are excluded, this treatment must be followed consistently over time.

#### § 615.5210 Risk-adjusted assets.

(a) *Computation.* Each asset on the institution's balance sheet and each off-balance-sheet item, adjusted by the appropriate credit conversion factor in § 615.5212, is assigned to one of the risk categories specified in § 615.5211. The aggregate dollar value of the assets in each category is multiplied by the percentage weight assigned to that category. The sum of the weighted dollar values from each of the risk categories comprises "risk-adjusted assets," the denominator for computation of the permanent capital ratio.

(b) *Ratings-based approach.* (1) Under the ratings-based approach, a rated position in a securitization (provided it satisfies the criteria specified in paragraph (b)(3) of this section) is assigned to the appropriate risk-weight category based on its external rating.

(2) Provided they satisfy the criteria specified in paragraph (b)(3) of this section, the following positions qualify for the ratings-based approach:

- (i) Recourse obligations;
- (ii) Direct credit substitutes;
- (iii) Residual interests (other than credit-enhancing interest-only strips); and
- (iv) Asset-or mortgage-backed securities.

(3) A position specified in paragraph (b)(2) of this section qualifies for a ratings-based approach provided it satisfies the following criteria:

- (i) If the position is traded and externally rated, its long-term external

rating must be one grade below investment grade or better (e.g., BB or better) or its short-term external rating must be investment grade or better (e.g., A-3, P-3). If the position receives more than one external rating, the lowest rating applies.

(ii) If the position is not traded and is externally rated,

(A) It must be externally rated by more than one NRSRO;

(B) Its long-term external rating must be one grade below investment grade or better (e.g., BB or better) or its short-term external rating must be investment grade or better (e.g., A-3, P-3 or better). If the ratings are different, the lowest rating applies;

(C) The ratings must be publicly available; and

(D) The ratings must be based on the same criteria used to rate traded positions.

(c) *Positions in securitizations that do not qualify for a ratings-based approach.*

The following positions in securitizations do not qualify for a ratings-based approach. They are treated as indicated.

(1) For any residual interest that is not externally rated, the institution must deduct from capital and assets the face amount of the position (dollar-for-dollar reduction).

(2) For any credit-enhancing interest-only strip, the institution must deduct from capital and assets the face amount of the position (dollar-for-dollar reduction).

(3) For any position that has a long-term external rating that is two grades below investment grade or lower (e.g., B or lower) or a short-term external rating that is one grade below investment grade or lower (e.g., B or lower, Not Prime), the institution must deduct from capital and assets the face amount of the position (dollar-for-dollar reduction).

(4) Any recourse obligation or direct credit substitute (e.g., a purchased subordinated security) that is not externally rated is risk weighted using the amount of the recourse obligation or direct credit substitute and the full amount of the assets it supports, *i.e.*, all the more senior positions in the structure. This treatment is subject to the low-level exposure rule set forth in paragraph (e) of this section. This amount is then placed into a risk-weight category according to the obligor or, if relevant, the guarantor or the nature of the collateral.

(5) Any stripped mortgage-backed security or similar instrument, such as an interest-only strip that is not credit-enhancing or a principal-only strip (including such instruments guaranteed

by Government-sponsored agencies), is assigned to the 100-percent risk-weight category described in § 615.5211(d)(7).

(d) *Senior positions not externally rated.* For a position in a securitization that is not externally rated but is senior in all features to a traded position (including collateralization and maturity), an institution may apply a risk weight to the face amount of the senior position based on the traded position's external rating. This section will apply only if the traded position provides substantial credit support for the entire life of the unrated position.

(e) *Low-level exposure rule.* If the maximum contractual exposure to loss retained or assumed by an institution in connection with a recourse obligation or a direct credit substitute is less than the effective risk-based capital requirement for the credit-enhanced assets, the risk-based capital required under paragraph (c)(4) of this section is limited to the institution's maximum contractual exposure, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply when an institution provides credit enhancement beyond any contractual obligation to support assets it has sold.

(f) *Reservation of authority.* The FCA may, on a case-by-case basis, determine the appropriate risk weight for any asset or credit equivalent amount that does not fit wholly within one of the risk categories set forth in § 615.5211 or that imposes risks that are not commensurate with the risk weight otherwise specified in § 615.5211 for the asset or credit equivalent. In addition, the FCA may, on a case-by-case basis, determine the appropriate credit conversion factor for any off-balance sheet item that does not fit wholly within one of the credit conversion factors set forth in § 615.5212 or that imposes risks that are not commensurate with the credit conversion factor otherwise specified in § 615.5212 for the item. In making this determination, the FCA will consider the similarity of the asset or off-balance sheet item to assets or off-balance sheet items explicitly treated in §§ 615.5211 or 615.5212, as well as other relevant factors.

#### **§ 615.5211 Risk categories—balance sheet assets.**

Section 615.5210(c) specifies certain balance sheet assets that are not assigned to the risk categories set forth below. All other balance sheet assets are assigned to the percentage risk categories as follows:

(a) *Category 1: 0 Percent.*

(1) Cash (domestic and foreign).

(2) Balances due from Federal Reserve Banks and central banks in other OECD countries.

(3) Direct claims on, and portions of claims unconditionally guaranteed by, the U.S. Treasury, government agencies, or central governments in other OECD countries.

(4) Portions of local currency claims on, or unconditionally guaranteed by, non-OECD central governments (including non-OECD central banks), to the extent the institution has liabilities booked in that currency.

(5) Claims on, or guaranteed by, qualifying securities firms that are collateralized by cash held by the institution or by securities issued or guaranteed by the United States (including U.S. Government agencies) or OECD central governments, provided that a positive margin of collateral is required to be maintained on such a claim on a daily basis, taking into account any change in the institution's exposure to the obligor or counterparty under the claim in relation to the market value of the collateral held in support of the claim.

(b) *Category 2: 20 Percent.*

(1) Cash items in the process of collection.

(2) Loans and other obligations of and investments in Farm Credit institutions.

(3) All claims (long- and short-term) on, and portions of claims (long- and short-term) guaranteed by, OECD banks.

(4) Short-term (remaining maturity of 1 year or less) claims on, and portions of short-term claims guaranteed by, non-OECD banks.

(5) Portions of loans and other claims conditionally guaranteed by the U.S. Treasury, government agencies, or central governments in other OECD countries and portions of local currency claims conditionally guaranteed by non-OECD central governments to the extent that the institution has liabilities booked in that currency.

(6) All securities and other claims on, and portions of claims guaranteed by, Government-sponsored agencies.

(7) Portions of loans and other claims (including repurchase agreements) collateralized by securities issued or guaranteed by the U.S. Treasury, government agencies, Government-sponsored agencies or central governments in other OECD countries.

(8) Portions of loans and other claims collateralized by cash held by the institution or its funding bank.

(9) General obligation claims on, and portions of claims guaranteed by, the full faith and credit of states or other political subdivisions or OECD

countries, including U.S. state and local governments.

(10) Claims on, and portions of claims guaranteed by, official multinational lending institutions or regional development institutions in which the U.S. Government is a shareholder or a contributing member.

(11) Portions of claims collateralized by securities issued by official multilateral lending institutions or regional development institutions in which the U.S. Government is a shareholder or contributing member.

(12) Investments in shares of mutual funds whose portfolios are permitted to hold only assets that qualify for the zero or 20-percent risk categories.

(13) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset-or mortgage-backed securities that are externally rated in the highest or second highest investment grade category, *e.g.*, AAA, AA, in the case of long-term ratings, or the highest rating category, *e.g.*, A-1, P-1, in the case of short-term ratings.

(14) Claims on, and claims guaranteed by, qualifying securities firms provided that:

(i) The qualifying securities firm, or at least one issue of its long-term debt, has a rating in one of the highest two investment grade rating categories from an NRSRO (if the securities firm or debt has more than one NRSRO rating the lowest rating applies); or

(ii) The claim is guaranteed by a qualifying securities firm's parent company with such a rating.

(15) Certain collateralized claims on qualifying securities firms without regard to satisfaction of the rating standard, provided that the claim arises under a contract that:

(i) Is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed under standard industry documentation;

(ii) Is collateralized by liquid and readily marketable debt or equity securities;

(iii) Is marked-to-market daily;

(iv) Is subject to a daily margin maintenance requirement under the standard documentation; and

(v) Can be liquidated, terminated, or accelerated immediately in bankruptcy or similar proceedings, and the security or collateral agreement will not be stayed or avoided, under applicable law of the relevant country.

(16) Claims on other financing institutions provided that:

(i) The other financing institution qualifies as an OECD bank or it is owned and controlled by an OECD bank that guarantees the claim, or

(ii) The other financing institution has a rating in one of the highest three investment-grade rating categories from a NRSRO or the claim is guaranteed by a parent company with such a rating, and

(iii) The other financing institution has endorsed all obligations it pledges to its funding Farm Credit bank with full recourse.

(c) *Category 3: 50 Percent.*

(1) All other investment securities with remaining maturities under 1 year, if the securities are not eligible for the ratings-based approach or subject to the dollar-for-dollar capital treatment.

(2) Qualified residential loans.

(3) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset-or mortgage-backed securities that are rated in the third highest investment grade category, *e.g.*, A, in the case of long-term ratings, or the second highest rating category, *e.g.*, A-2, P-2, in the case of short-term ratings.

(4) Revenue bonds or similar obligations, including loans and leases, that are obligations of state or political subdivisions of the United States or other OECD countries but for which the government entity is committed to repay the debt only out of revenue from the specific projects financed.

(5) Claims on other financing institutions that:

(i) Are not covered by the provisions of paragraph (b)(17) of this section, but otherwise meet similar capital, risk identification and control, and operational standards, or

(ii) Carry an investment-grade or higher NRSRO rating or the claim is guaranteed by a parent company with such a rating, and

(iii) The other financing institution has endorsed all obligations it pledges to its funding Farm Credit bank with full recourse.

(d) *Category 4: 100 Percent.* This category includes all assets not specified in the categories above or below nor deducted dollar-for-dollar from capital and assets as discussed in § 615.5210(c). This category comprises standard risk assets such as those typically found in a loan or lease portfolio and includes:

(1) All other claims on private obligors.

(2) Claims on, or portions of claims guaranteed by, non-OECD banks with a remaining maturity exceeding 1 year.

(3) Claims on, or portions of claims guaranteed by, non-OECD central governments that are not included in paragraphs (a)(4) or (b)(4) of this section, and all claims on non-OECD state and local governments.

(4) Industrial-development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest.

(5) Premises, plant, and equipment; other fixed assets; and other real estate owned.

(6) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset-or mortgage-backed securities that are rated in the lowest investment grade category, *e.g.*, BBB, in the case of long-term ratings, or the third highest rating category, *e.g.*, A-3, P-3, in the case of short-term ratings.

(7) Stripped mortgage-backed securities and similar instruments, such as interest-only strips that are not credit-enhancing and principal-only strips (including such instruments guaranteed by Government-sponsored agencies).

(8) Investments in Rural Business Investment Companies.

(9) If they have not already been deducted from capital:

(i) Investments in unconsolidated companies, joint ventures, or associated companies.

(ii) Deferred-tax assets.

(iii) Servicing assets.

(10) All non-local currency claims on foreign central governments, as well as local currency claims on foreign central governments that are not included in any other category.

(11) Claims on other financing institutions that do not otherwise qualify for a lower risk-weight category under this section; and

(12) All other assets not specified above, including but not limited to leases and receivables.

(e) *Category 5: 200 Percent.* Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset-or mortgage-backed securities that are rated one category below the lowest investment grade category, *e.g.*, BB.

**§ 615.5212 Credit conversion factors—off-balance sheet items.**

(a) The face amount of an off-balance sheet item is generally incorporated into risk-weighted assets in two steps. For most off-balance sheet items, the face amount is first multiplied by a credit conversion factor. (In the case of direct credit substitutes and recourse obligations the full amount of the assets enhanced are multiplied by a credit conversion factor). The resultant credit equivalent amount is assigned to the

appropriate risk-weight category described in § 615.5211 according to the obligor or, if relevant, the guarantor or the collateral.

(b) Conversion factors for various types of off-balance sheet items are as follows:

(1) 0 Percent.

(i) Unused commitments with an original maturity of 14 months or less;

(ii) Unused commitments with an original maturity greater than 14 months if:

(A) They are unconditionally cancellable by the institution; and

(B) The institution has the contractual right to, and in fact does, make a separate credit decision based upon the borrower's current financial condition before each drawing under the lending arrangement.

(2) 20 Percent. Short-term, self-liquidating, trade-related contingencies, including but not limited to commercial letters of credit.

(3) 50 Percent.

(i) Transaction-related contingencies (e.g., bid bonds, performance bonds, warranties, and performance-based

standby letters of credit related to a particular transaction).

(ii) Unused loan commitments with an original maturity greater than 14 months, including underwriting commitments and commercial credit lines.

(iii) Revolving underwriting facilities (RUFs), note issuance facilities (NIFs) and other similar arrangements pursuant to which the institution's customer can issue short-term debt obligations in its own name, but for which the institution has a legally binding commitment to either:

(A) Purchase the obligations its customer is unable to sell by a stated date; or

(B) Advance funds to its customer if the obligations cannot be sold.

(4) 100 Percent.

(i) The full amount of the assets supported by direct credit substitutes and recourse obligations for which an institution directly or indirectly retains or assumes credit risk. For risk participations in such arrangements acquired by the institution, the full amount of assets supported by the main obligation multiplied by the acquiring

institution's percentage share of the risk participation. The capital requirement under this paragraph is limited to the institution's maximum contractual exposure, less any recourse liability account established under generally accepted accounting principles.

(ii) Acquisitions of risk participations in bankers acceptances.

(iii) Sale and repurchase agreements, if not already included on the balance sheet.

(iv) Forward agreements (i.e., contractual obligations) to purchase assets, including financing facilities with certain drawdown.

(c) *Credit equivalents of interest rate contracts and foreign exchange contracts.* (1) Credit equivalents of interest rate contracts and foreign exchange contracts (except single-currency floating/floating interest rate swaps) are determined by adding the replacement cost (mark-to-market value, if positive) to the potential future credit exposure, determined by multiplying the notional principal amount by the following credit conversion factors as appropriate.

**CONVERSION FACTOR MATRIX**  
(In percent)

Remaining maturity	Interest rate	Exchange rate	Commodity
1 year or less .....	0.0	1.0	10.0
Over 1 to 5 years .....	0.5	5.0	12.0
Over 5 years .....	1.5	7.5	15.0

(2) For any derivative contract that does not fall within one of the categories in the above table, the potential future credit exposure is to be calculated using the commodity conversion factors. The net current exposure for multiple derivative contracts with a single counterparty and subject to a qualifying bilateral netting contract is the net sum of all positive and negative mark-to-market values for each derivative contract. The positive sum of the net current exposure is added to the adjusted potential future credit exposure for the same multiple contracts with a single counterparty. The adjusted potential future credit exposure is computed as  $A_{net} = (0.4 \times A_{gross}) + 0.6 (NGR \times A_{gross})$  where:

(i)  $A_{net}$  is the adjusted potential future credit exposure;

(ii)  $A_{gross}$  is the sum of potential future credit exposures determined by multiplying the notional principal amount by the appropriate credit conversion factor; and

(iii) NGR is the ratio of the net current credit exposure divided by the gross current credit exposure determined as the sum of only the positive mark-to-markets for each derivative contract with the single counterparty.

(3) Credit equivalents of single-currency floating/floating interest rate swaps are determined by their replacement cost (mark-to-market).

**Subpart K—Surplus and Collateral Requirements**

■ 10. Amend § 615.5301 by revising paragraphs (b)(3), (i)(2), and (i)(8) to read as follows:

**§ 615.5301 Definitions.**

\* \* \* \* \*

(b) \* \* \*

(3) The deductions that must be made by an institution in the computation of its permanent capital pursuant to § 615.5207(f), (g), (i), and (k) shall also be made in the computation of its core surplus. Deductions required by § 615.5207(a) shall also be made to the

extent that they do not duplicate deductions calculated pursuant to this section and required by § 615.5330(b)(2).

\* \* \* \* \*

(i) \* \* \*

(2) Allocated equities, including allocated surplus and stock, that are not subject to a plan or practice of revolvment or retirement of 5 years or less and are eligible to be included in permanent capital pursuant to paragraph(4)(iv) of the definition of permanent capital in § 615.5201; and

\* \* \* \* \*

(8) Any deductions made by an institution in the computation of its permanent capital pursuant to § 615.5207 shall also be made in the computation of its total surplus.

\* \* \* \* \*

**§ 615.5330 [Amended]**

■ 11. Amend § 615.5330 by removing the reference “§ 615.5210(f)” and adding in its place “§ 615.5210” in paragraphs (a)(2) and (b)(3).

**PART 620—DISCLOSURE TO SHAREHOLDERS**

- 12. The authority citation for part 620 continues to read as follows:

**Authority:** Secs. 5.17, 5.19, 8.11 of the Farm Credit Act (12 U.S.C. 2252, 2254,

2279aa–11); secs. 424 of Pub. L. 100–233, 101 Stat. 1568, 1656.

**Subpart A—General****§ 620.1 [Amended]**

- 13. Amend § 620.1(j) by removing the reference “§ 615.5201(l)” and adding in its place “§ 615.5201.”

Dated: June 9, 2005.

**Jeanette C. Brinkley,**

*Secretary, Farm Credit Administration Board.*

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