

FARM CREDIT ADMINISTRATION**12 CFR Part 615**

RIN 3052-AC50

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Investment Management

AGENCY: Farm Credit Administration.

ACTION: Final rule.

SUMMARY: The Farm Credit Administration (FCA, Agency, us, our, or we) issues this final rule to amend our regulations governing investments held by institutions of the Farm Credit System (FCS or System), as well as related regulations. This final rule strengthens our regulations governing investment management and interest rate risk management; reduces regulatory burden for investments that fail to meet eligibility criteria after purchase; and makes other changes that will enhance the safety and soundness of System institutions.

DATES: This regulation will be effective 30 days after publication in the **Federal Register** during which either or both Houses of Congress are in session. We will publish a notice of the effective date in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT:

Timothy T. Nerdahl, Senior Financial Analyst, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (952) 854-7151 extension 5035, TTY (952) 854-2239;

Or

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

SUPPLEMENTARY INFORMATION:**I. Objectives**

The objectives of this rule are to:

- Ensure that Farm Credit banks¹ hold sufficient high-quality, readily marketable investments to provide sufficient liquidity to continue operations and pay maturing obligations in the event of market disruption;
- Strengthen the safety and soundness of System institutions;
- Reduce regulatory burden with respect to investments that fail to meet eligibility criteria after purchase; and
- Enhance the ability of the System to supply credit to agriculture and aquatic producers by ensuring adequate availability to funds.

¹ Section 619.9140 of FCA regulations defines Farm Credit bank to include Farm Credit Banks, agricultural credit banks, and banks for cooperatives.

II. Background

Congress created the System as a Government-sponsored enterprise (GSE) to provide a permanent, stable, and reliable source of credit and related services to American agricultural and aquatic producers. Farm Credit banks obtain funds that they and System associations use to provide credit and related services primarily through the issuance of Systemwide debt securities.² If access to the debt market becomes temporarily impeded, Farm Credit banks must have enough readily available funds to continue operations and pay maturing obligations. Subpart E of part 615 imposes comprehensive requirements regarding the investments of System institutions in order to ensure continuity of operations.

III. History of Rule

We adopted our last major revisions to our investment regulations in 1999 and amended them in a more limited manner in 2005. Since 1999, the marketplace pertaining to investments has changed significantly. Innovations in investment products have led to their increasing complexity, and investors need to have greater expertise to fully understand them. In addition, the financial crisis that began in 2007 resulted in numerous investment downgrades and the loss of billions of dollars by financial institutions. While System banks suffered considerably less stress during the crisis than many other financial institutions, they did experience numerous downgrades and some losses on individual investments.

In 2010, we issued FCA Bookletter BL-064, which provided clarification and guidance regarding our regulations and expectations with respect to the key elements of a robust investment asset management framework that institutions should establish to prudently manage their investments in changing markets.³ The issuance of this booklet was an interim measure towards strengthening our investment regulations.

On August 18, 2011, we published a proposed rule to amend FCA's regulations governing System investments.⁴ Our intention was to strengthen and enhance board governance and controls and clarify our expectations over investment

² Farm Credit banks use the Federal Farm Credit Banks Funding Corporation (Funding Corporation) to issue and market Systemwide debt securities. The Funding Corporation is owned by the Farm Credit banks.

³ FCA Bookletter BL-064, *Farm Credit System Investment Asset Management* (December 9, 2010). This Bookletter may be viewed at www.fca.gov. Under Quick Links, click on Bookletters.

⁴ 76 FR 51289.

management practices, while reducing regulatory burden in several areas. After considering the comments we received on the proposed rule, we now plan to finalize the proposed provisions contained in the proposed rule in installments.

This first installment of final regulations will revise the following regulations:

- § 615.5131—Definitions;
- § 615.5132—Investment Purposes;
- § 615.5133—Investment Management;
- § 615.5136—Emergencies Impeding Normal Access of Farm Credit Banks to Capital Markets;
- § 615.5143—Management of Ineligible Investments and Reservation of Authority to Require Divestiture;
- § 615.5174—Farmer Mac Securities;
- § 615.5180—Bank Interest Rate Risk Management Program; and
- § 615.5182—Interest Rate Risk Management by Associations and Other Farm Credit System Institutions Other Than Banks.

In addition, we are making minor technical conforming revisions to § 615.5140 and to § 615.5201, which is the Definitions section in our capital adequacy regulations.

Finally, we are deleting the following existing provisions:

- § 615.5135—Management of Interest Rate Risk (we are incorporating its provisions, as amended, into § 615.5180);
- § 615.5141—Stress Tests for Mortgage Securities (we are incorporating its provisions, as amended, into §§ 615.5133(f)(1)(iii) and 615.5133(f)(4)); and
- § 615.5181—Bank Interest Rate Risk Management Program (we are incorporating its provisions, as amended, into § 615.5180).

We intend to address in one or more future rulemakings regulations covering all the areas of the proposed rule not covered in this final rule, including investment eligibility (including revised creditworthiness requirements) and association investments. The regulations that we proposed to revise but that we are not revising at this time include:

- § 615.5140—Eligible Investments (except for minor technical changes); and
- § 615.5142—Association Investments.

This final regulation codifies much of the guidance that was contained in BL-064. In many areas, however, the regulation imposes requirements that go beyond the Bookletter's guidance.

Although the Bookletter may continue to provide useful guidance, institutions must be sure that they are complying with the requirements in this regulation.

Because we are not at this time finalizing revisions to § 615.5142, governing association investments, the guidance on association investments in BL-064, which clarifies existing § 615.5142, will continue to be relevant. In addition, institutions should be mindful of our Informational Memorandum on Association Investments dated May 16, 2012, which reminds banks and associations of their obligations under § 615.5142.

IV. Discussion of Comment Letters and Section-by-Section Analysis of Final Rule

FCA received comment letters from two Farm Credit banks—CoBank, ACB and the Farm Credit Bank of Texas. FCA also received comment letters from four Farm Credit associations—Colonial Farm Credit, ACA, FCS Financial, ACA, Farm Credit Services of Mid-America, ACA, and AgStar Financial Services, ACA. In addition, the Farm Credit Council (Council) submitted comments that were developed with input from a workgroup that includes financial officers from several associations, all Farm Credit banks, and the Federal Farm Credit Banks Funding Corporation (Funding Corporation). Finally, we also considered a comment letter the Council submitted to FCA on a similar proposed rule governing the Federal Agricultural Mortgage Corporation (Farmer Mac)⁵ that generally encouraged us to make the requirements of the two rules more similar. Although the two final rules continue to differ where appropriate, changes were made to both this rule and the Farmer Mac rule to make the requirements more similar.⁶

We received many constructive comments on the proposed rule. In general, the commenters stated that several of the provisions would enhance investment management at System institutions. They also stated, however, that many provisions of the proposed rule were inordinately and unnecessarily prescriptive.

The Council also commented generally that the rule is unnecessary in light of FCA Bookletter BL-064. In response, we believe it is prudent to codify the booklet's guidance into regulation. In addition, as stated above, in many areas the regulation imposes requirements that go beyond the booklet's guidance. Accordingly, this regulation is necessary notwithstanding FCA Bookletter BL-064.

We will address each specific comment received in our discussion of the regulation provision to which the comment relates. Those areas of the proposed rule not receiving comment or receiving positive comments are finalized as proposed unless otherwise discussed in this preamble. Throughout this regulation, we make minor technical, clarifying, and non-substantive language changes that we do not specifically discuss in this preamble.

A. Section 615.5131—Definitions

We proposed to amend § 615.5131 to add definitions for the terms Government agency and Government-sponsored agency. The Council noted that FCA had already defined these terms in our capital adequacy regulation at § 615.5201. The Council stated that FCA and the other banking regulators “essentially define these terms identically” for capital purposes, and it asked us to conform the definitions.

We note that the definitions of these terms in the capital regulations of FCA and of other banking regulators such as the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) contain technical differences from one another.⁷ In an effort to bring additional clarity to these definitions, the definitions we proposed in this rulemaking also differed in technical ways from any of these other definitions. In the absence of definitive common definitions, we believe our technical differences from the other regulators are warranted. We agree, however, that FCA's definitions should be consistent among themselves. Accordingly, we are finalizing the § 615.5131 definitions as proposed with minor technical changes and, as discussed below, we are revising the definitions in § 615.5201 to conform.

Section 615.5131 defines Government agency as the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations are fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States Government. Section 615.5131 defines Government-sponsored agency as an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the United States Congress but whose obligations are not

fully and explicitly insured or guaranteed by the full faith and credit of the United States Government. This definition includes GSEs such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), as well as Federal agencies, such as the Tennessee Valley Authority, that issue obligations that are not explicitly guaranteed by the Government of the United States' full faith and credit.

B. Section 615.5132—Investment Purposes

Section 615.5132 permits each Farm Credit bank to hold eligible investments, for specified purposes,⁸ in an amount not to exceed 35 percent of its total outstanding loans. We remind banks that generating earnings is not an authorized investment purpose, although it is permissible if the earnings are incidental to one or more of the specified investment purposes.⁹

In our proposed rule, we asked whether the 35-percent investment limit should be raised. Commenters responded that this limit was appropriate, as long as our regulations permitted the exclusion of certain investments. We discuss these comments, and our responses, below.

1. Exclusion of Investments Pledged To Meet Margin Requirements for Derivative Transactions

In § 615.5132(b)(1), we adopt as final our proposal to permit Farm Credit banks to exclude investments pledged to meet margin requirements for derivative transactions (collateral) when calculating the 35-percent investment limit under paragraph (a). We note that investments that are pledged as collateral do not count toward a Farm Credit bank's compliance with its liquidity requirements.¹⁰ We make this change because derivatives are used as a hedging tool against interest rate risk and liquidity risk. Farm Credit banks use derivative products as an integral part of their interest rate risk

⁸ The specified purposes are maintaining a liquidity reserve, managing surplus short-term funds, and managing interest rate risk.

⁹ We also remind associations that, pursuant to § 615.5142, which we are not amending today, their only authorized investment purposes are reducing interest rate risk and managing surplus short-term funds. One association commenter suggested that it holds investments to augment income. As with banks, augmenting income through investments is permissible only if such income is incidental to one or more of the authorized investment purposes. Under § 611.1135(a), service corporations may hold investments for the purposes authorized for their organizers.

¹⁰ Under § 615.5134(b), all investments that a bank holds for the purpose of meeting the liquidity reserve requirement must be free of lien.

⁵ 76 FR 71798 (November 18, 2011).

⁶ In the interest of consistency, the FCA Board adopted the final rule governing Farmer Mac's investment management at the same time it adopted this final rule. That final rule is also published in today's issue of the **Federal Register**.

⁷ See, e.g., 12 CFR Part 208, App. A (FRB); 12 CFR Part 225, App. A (FRB); 12 CFR Part 325, App. A (FDIC); 12 CFR Part 3, App. A (OCC).

management activities and as a supplement to the issuance of debt securities in the capital markets. We recognize that banks are required to post collateral to counterparties resulting from entering into derivative transactions, and we believe banks should not be discouraged from implementing appropriate risk management practices. We received positive comments on this proposal from the Council and a bank.

2. Exclusion of Other Investments

Some commenters requested that we also exclude certain other investments from the 35-percent limit. They requested that we exclude securities purchased and designated for the primary purpose of posting collateral for derivative positions, even if the collateral is returned or the securities are never posted. These commenters stated that including these securities in the 35-percent limit would require a bank to maintain a cushion under the limit to accommodate the possibility of return, thereby limiting the amount of other investments it can hold to manage its liquidity position and derivative counterparty exposures.

Commenters also requested that we exclude Treasury securities from the 35-percent limit. They stated that including Treasury securities in the limit crowds out other higher-yielding, high-quality liquid investments. Thus, their inclusion in the limit creates an economic constraint and disincentive to holding Treasury securities, even though they are the most liquid and marketable investment. They requested that we treat Treasury securities like cash and exclude them from the 35-percent limit.

Finally, the Council requested that investment securities pledged in secured borrowing relationships be excluded from the 35-percent limit. The Council cited State Ag-Linked lending programs and repurchase agreements as examples of these secured borrowing relationships. Under both arrangements, according to the Council, the pledging of securities acts as an alternative that provides cash for operations without the issuance of new Federal Farm Credit Banks debt obligations. Under § 615.5134(b), these investments may not be counted in the liquidity reserve because they are not unencumbered. The Council asserts that excluding pledged securities from the 35-percent limit would be consistent with use of the securities as an alternative method to secure financing and their treatment under the FCA regulatory liquidity measurement.

We decline to exclude these investments from the investment limit on a blanket basis. We view these types of transactions as part of a Farm Credit bank's normal cash management operations. Thus, under normal conditions, we expect each Farm Credit bank to manage the level of its investments within FCA's portfolio size limits to ensure regulatory compliance. As discussed below, however, we are providing additional flexibility to each bank in the management of its investment portfolio by revising the regulation to allow compliance with the limit on a 30-day average daily balance (ADB) basis rather than on a daily basis; this change will enable a bank to exceed the investment limit temporarily, as long as its 30-day ADB is below the limit. Moreover, final § 615.5132(b)(2) permits the exclusion from the investment limit of other investments as FCA determines is appropriate.

3. Revision to Calculation

In order to provide Farm Credit banks with additional flexibility to manage their investment portfolio, we are modifying how the 35-percent investment limit is calculated in paragraph (a).

The numerator (investments) will be calculated as a 30-day ADB of investments measured at amortized cost, excluding interest and net of all collateral pledged for derivative purposes and any other investments for which FCA has approved exclusions. The calculation of the denominator (total outstanding loans) remains unchanged, although the regulation makes explicit our existing interpretation that total loans include accrued interest and do not include allowance for loan loss.¹¹ Compliance will only be measured at month end.

Example of the January 31, 2012 calculation: 30-day ADB of investments as of January 31, 2012 divided by the 90-day ADB of total outstanding loans as of December 31, 2011.

Example of the March 31, 2012 calculation: 30-day ADB of investments as of March 31, 2012 divided by the 90-day ADB of total outstanding loans as of March 31, 2012.

We believe this modification of the 35-percent calculation will provide additional flexibility for Farm Credit banks in managing their investment portfolios. Because FCA will evaluate compliance at month end and on a 30-day ADB rather than the actual daily balance, a bank that receives a large

amount of returned collateral that temporarily increases its investment portfolio above 35 percent on a particular day, for example, should still be below the 35-percent ADB—unless it is managing its investment portfolio too close to the 35-percent limit.

C. Section 615.5133—Investment Management

Effective investment management requires financial institutions to establish policies that include risk limits, approved mechanisms for identifying, measuring, and reporting exposures, and strong corporate governance. The recent crisis and its lingering effects have re-emphasized the importance of sound investment management, and we believe that strengthened regulation would further ensure the safe and sound management of investments. Accordingly, we are making significant changes to § 615.5133, which governs investment management.

One association commented that the economic impact of certain proposals on small associations could be profound, because they cannot afford a bank's level of investment management expertise. The association recognizes that association boards and management have a fiduciary duty to manage investments in a safe and sound manner, but it stated that it depends on its funding bank, in its approval role, to provide advice regarding unwise investment decisions. In addition, according to the association commenter, requiring associations to add unnecessary investment management committees, policies, analyses, and reports increases expenses and decreases the benefits of investments.

Revised § 615.5133(b), which we discuss in greater detail below, requires investment policies to be sufficiently detailed, consistent with, and appropriate for the amounts, types, and risk characteristics of an institution's investments.¹² As we stated in 1999 and have repeated since that time, bank oversight does not absolve an association's board and managers of their fiduciary responsibilities to manage investments in a safe and sound manner. The fiduciary responsibilities of association boards obligate them to develop appropriate investment management policies and practices to manage the risks associated with investment activities. Moreover, each association's investment managers must fully understand the risks of its investments and make independent and

¹¹ Section 615.5131 provides that loans are calculated quarterly (as of the last day of March, June, September, and December) by using the ADB of loans during the quarter.

¹² The existing language imposes similar requirements.

objective evaluations of investments prior to purchase. An association must comply with all the requirements in § 615.5133 if the level or type of its investments could expose its capital to material loss.

A bank's approval serves as an additional safeguard for an association's investments, but the association must nevertheless have the requisite expertise to manage the investments that it holds.

1. Section 615.5133(a)—Responsibilities of Board of Directors

The Council commented that the proposed requirement that the board (or a designated committee of the board) must, at least annually, review and "affirmatively validate" the sufficiency of its investment policies is overly prescriptive, burdensome, and unclear. We agree that a review requirement is sufficient and delete "affirmatively validate" from the final rule.

We also move to this section and clarify a documentation requirement that we had proposed in § 615.5133(b). We had proposed to require institutions to document in their records or board minutes any analyses used in formulating their policies or amendments to the policies. The Council stated that suggesting board minutes as a place to document this analysis is burdensome and does not enhance the investment management process. We do not agree that suggesting board minutes as an optional location for documentation is burdensome. Nevertheless, we revise the last sentence of § 615.5133(a) to require that any changes to the policies must be documented, without specifying a location.

The revisions in this paragraph are otherwise unchanged from the proposed rule. All other comments supported the proposed revisions in this provision.

2. Section 615.5133(b)—Investment Policies—General Requirements

The Council commented that the revisions in this proposed paragraph appeared reasonable overall. We move from § 615.5133(f)(1) a sentence requiring investment policies to fully address the extent of pre-purchase analysis that management must perform for various classes of investments. Otherwise, except for several minor non-substantive technical changes, the revisions in this paragraph are unchanged from the proposed rule.

3. Section 615.5133(c)—Investment Policies—Risk Tolerance

We received comment on the clarity of the proposed language in this provision. Accordingly, we are

clarifying the requirements in final § 615.5133(c) to require that investment policies must include concentration limits to ensure prudent diversification of credit, market, and liquidity risk in the investment portfolio.

In addition, our proposed rule, as well as our existing rule, provides that risk limits must be based on an institution's institutional objectives, capital position, and risk tolerance. In the final rule, we are requiring that risk limits be based on all relevant factors, including an institution's institutional objectives, capital position, earnings, and quality and reliability of risk management systems. In addition, in light of our relocation of our interest rate risk management requirements to another subpart of these regulations (discussed below), we are making explicit that risk limits must also consider the interest rate risk management program required for banks and associations.

a. Section 615.5133(c)(1)—Credit Risk

Existing § 615.5133(c)(1)(ii) requires an institution's board to review annually the investment policy criteria for selecting securities firms and to determine whether to continue the institution's existing relationships with them. To reduce regulatory burden, we proposed to permit a designated committee of the board to review the criteria and to determine whether to continue existing relationships, but the board would have had to approve any changes to the criteria or to the existing relationships.

Both the Council and a bank objected to the existing requirement that the board must determine whether to continue an institution's existing relationships with securities firms. They commented that this requirement is confusing, creates an excessive burden, and results in an unnecessary distraction for the board.

We agree that as long as an institution's board (or a designated committee) reviews the selection criteria on an annual basis, and the board approves any changes to the criteria, the board does not need to be involved in the approval of the relationships. Accordingly, we have deleted the existing and proposed requirements of board involvement in an institution's relationships with securities firms.

Existing § 615.5133(c)(1)(iii) requires investment policies to establish collateral margin requirements on repurchase agreements. We proposed to require institutions to regularly mark the collateral to market and ensure appropriate controls are maintained over collateral held. We received

positive comments on this provision and adopt it as proposed.

b. Section 615.5133(c)(2)—Market Risk

Existing § 615.5133(c)(2) requires an institution's board to establish market risk limits in accordance with our regulations and other policies. In our proposed rule, we specifically identified these other regulations as those governing stress testing and interest rate risk.

The Council objected to the proposed revision, stating that it did not appear to add a new requirement but that it could be used to impose duplicative requirements. In addition, the Council vigorously objected to the proposed and existing reference to "other policies"; because these policies have not been subject to notice and comment rulemaking, we cannot require compliance with them in this regulation.

In response to these comments, the final regulation, like the existing regulation, requires investment policies to set market risk limits for specific types of investments and for the investment portfolio.¹³ We believe this requirement is sufficient and the reference to our "regulations and * * * other policies" is not needed.

4. Section 615.5133(e)—Internal Controls

Existing § 615.5133(e)(2) requires System institutions to establish and maintain a separation of duties and supervision between personnel who execute investment transactions and personnel who approve, reevaluate, and oversee investments. Proposed § 615.5133(e)(2) would have added to the list of personnel whose duties and supervision would have had to be separated from personnel who execute investment transactions. These additional personnel would have been those who post accounting entries, reconcile trade confirmations, and report compliance with investment policy.

Both the Council and a bank objected to this proposed revision as overly prescriptive. In response, rather than itemizing all of the possible personnel functions, final § 615.5133(e)(2) provides that System institutions must establish and maintain a separation of duties between personnel who supervise or execute investment transactions and personnel who supervise or engage in all other investment-related functions. These other investment-related functions

¹³ We adopt our proposed technical changes to this provision.

include those itemized in the list in the proposed rule, as well as any other functions that are investment-related. Examples of those items in the proposed rule include but are not limited to posting accounting entries and reconciling trade confirmations. This regulation does not prohibit one person from performing or supervising more than one investment-related function, except that the same person cannot supervise or execute investment transactions and at the same time supervise or engage in any other investment-related function. Each institution must maintain appropriate controls as warranted by the complexity and risk of its investment operations.

Proposed § 615.5133(e)(4) would have added a new requirement that System institutions must implement effective internal audit programs to review, at least annually, their investment controls, processes, and compliance with FCA regulations and other regulatory guidance. Internal audit programs would have had to specifically include a review of the process for ensuring all investments, at the time of purchase, were eligible and suitable for purchase under the boards' investment policies.

The Council and both bank commenters stated that this requirement was too prescriptive and eliminated the flexibility that is necessary for an institution's internal auditors to establish its own risk-based approach to audits. An association encouraged FCA to set a de minimis investment portfolio amount relative to an association's total assets or total capital; investment portfolios under this amount would not be subject to annual risk assessments.

Final § 615.5133(e)(4) requires institutions to implement effective internal audit programs to review, at least annually, their investment management functions, controls, processes, and compliance with FCA regulations. The scope of the annual review must be appropriate for the size, risk, and complexity of the investment portfolio. Thus, while the final rule retains the annual audit requirement, it provides flexibility in determining the scope of the audit.

While the final rule allows for flexibility depending on the nature of an institution's investment portfolio, there is no bright line de minimis portfolio size that would permit an institution not to engage in risk assessment. As stated above, an association must comply with all the requirements in § 615.5133 if the level or type of its investments could expose its capital to material loss. Each association must have the ability to manage the investments that it holds.

In addition to the regulatory requirements in § 615.5133(e)(4), the guidance provided in BL-064 continues to be relevant for institutions in their development of internal audit processes.

5. Section 615.5133(f)—Due Diligence

As proposed, the final rule adds a new § 615.5133(f) that covers due diligence. This provision combines in one location the requirements governing securities valuation and those governing stress testing that are in existing § 615.5133(f) and § 615.5141, respectively.

In addition to the substantive changes to specific provisions, which we discuss below, we make extensive organizational and technical changes to make the structure and approach of this rule more similar to the rule governing Farmer Mac. We also make a number of minor technical and non-substantive changes to clarify the requirements.

a. Section 615.5133(f)(1)(i)—Eligibility, Purpose, and Compliance with Investment Policies

Proposed § 615.5133(f)(1) would have required a System institution, before it purchased an investment, to conduct sufficient due diligence to determine whether the investment was eligible and "suitable" for purchase under its board's investment policies. The institution would have been required to document this assessment.

This proposed requirement is retained in new § 615.5133(f)(1)(i), with minor clarifications. Since we had used the term "suitable" to mean an investment complied with the board's investment policies, we simplify the regulation by eliminating that term and instead requiring that an institution determine whether an investment complies with those policies. We also clarify that an institution must determine whether an investment is for an authorized purpose.

The Council and a bank commented that eligibility and the other pre-purchase assessments are often established for a class or segment of securities by specifying the criteria (credit risk, liquidity, market risk, etc.) that make a class of securities eligible and suitable per se, and they requested clarification that these pre-purchase assessments may be defined for segments or classes of securities that meet appropriate criteria rather than on a security-by-security basis. We note that the regulation does not prohibit the establishment of criteria for various classes or segments of investments, as long as an institution adequately documents its assessments.

We also added a sentence to § 615.5133(f)(1)(i) specifically

authorizing an institution, with board approval, to hold investments that do not comply with its investment policies. This addition recognizes that such decisions are within the discretion of the board's business judgment.¹⁴ This provision does not authorize the board to approve investments that do not comply with our regulatory eligibility requirements and purpose limitations.

b. Section 615.5133(f)(1)(ii)—Valuation

Existing § 615.5133(f)(1) requires a System institution to verify the value of a security that it plans to purchase, other than a new issue, with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction. We proposed no substantive changes to the requirement.

The Council objected to this existing requirement, commenting that verifying value from an independent source is not realistic for investments of tranches of collateralized mortgage obligations, including planned amortization class bonds, purchased in the primary market. The Council stated that these securities are generally unique in nature and their value, when newly created, will be impossible to verify with a third party prior to purchase.

In response, we reiterate that the third party pre-purchase valuation requirement explicitly excludes new issues. Accordingly, institutions need not seek third party pre-purchase valuation for new issues.

This valuation requirement and exclusion for new issues is retained in new § 615.5133(f)(1)(ii).

c. Section 615.5133(f)(1)(iii)—Risk Assessment

Like proposed § 615.5133(f)(1), new § 615.5133(f)(1)(iii) provides that an institution's assessment of each investment at the time of purchase must at a minimum include an evaluation of credit risk, liquidity risk, market risk, interest rate risk, and the underlying collateral of the investment.

The Council, a bank, and an association commented that while a comprehensive level of due diligence is appropriate for more risky and complex instruments such as mortgage-backed securities (MBS), such due diligence would be excessive and burdensome for instruments such as Treasury securities, federal funds investments, short-term commercial paper, discount notes, bullet bonds, and other less complex

¹⁴This authority incorporates and broadens proposed § 615.5133(f)(2)(i), which would have permitted an institution, with board approval, to purchase an investment that exceeds the stress-test parameters defined in its board policy.

and less risky securities. To ensure that we do not require more due diligence than is necessary, we add a provision that an institution's risk assessment must be commensurate with the complexity and risk in the investment.

The final rule specifies the risks that must be assessed but does not specify how these risks must be assessed. We explain in this preamble our expectations for how System institutions should assess their risk.

In their assessment of credit risk, System institutions should consider the nature and type of underlying collateral, credit enhancements, complexity of structure, and any other available indicators of the risk of default.

In their assessment of liquidity risk, System institutions should consider the investment structure, depth of the market, and ability to liquidate the position under a variety of economic scenarios and market conditions.

In their assessment of market risk, System institutions should consider how various market stress scenarios including, at a minimum, potential changes in interest rates and market conditions (such as market perceptions of creditworthiness), are likely to affect the cash flow and price of the instrument.

Proposed § 615.5133(f)(2) had required institutions to stress test all investments at the time of purchase. Commenters stated that while a pre-purchase stress-testing requirement is appropriate for complex securities such as MBS, asset-backed securities (ABS), and other non-Government guaranteed investments, it is inappropriate to require pre-purchase stress testing on instruments with low price sensitivity, such as Government-guaranteed investments and non-amortizing, bullet-type investments maturing within 1 year. Moreover, an association requested the establishment of a de minimis limit for stress testing even of higher-risk, more complex securities.

We agree that stress testing lower risk, less complex investments, such as overnight securities and commercial paper, may not provide value and may create excessive burden. Accordingly, final § 615.5133(f)(1)(iii) requires an institution to stress test before purchase only investments that are structured or that have uncertain cash flows, including all MBS and ABS. The stress test must be commensurate with the risk and complexity of the investment and must enable the institution to determine that the investment does not expose its capital, earnings, and liquidity to risks that exceed the risks specified in its

investment policies.¹⁵ The stress testing must comply with the requirements governing quarterly stress testing, which are discussed below.

We do not establish a de minimis amount below which stress testing need not be performed, because we believe that all high-risk, complex instruments must be stress tested. We note that final § 615.5133(f)(4) requires stress tests to be comprehensive and appropriate for the risk profile of each institution. Moreover, that provision also requires that the methodology an institution uses be appropriate for the complexity, structure, and cash flow of the investments in its portfolio.

d. Section 615.5133(f)(2)—Ongoing Value Determination

We retain the requirements of the first sentence of existing § 615.5133(f)(2), with slight wording changes.

e. Section 615.5133(f)(3)—Ongoing Analysis of Credit Risk

We move the second sentence of existing § 615.5133(f)(2) to § 615.5133(f)(3), with several changes. First, we delete the existing ongoing requirement to evaluate price sensitivity to market interest rates because that is adequately addressed in final § 615.5180(c)(3). Second, rather than requiring institutions to evaluate credit quality, we are requiring institutions to establish and maintain processes to monitor and evaluate changes in credit quality. Finally, we are retaining the existing requirement that institutions must analyze credit risk on an ongoing basis, rather than monthly, as we had proposed.

An association stated that it supported the proposed requirement to evaluate the credit quality of investments, provided fixed-rate, Government-guaranteed investments are excluded. We do not exclude these investments from this requirement because, like any other investments, the credit quality of Government-guaranteed investments can change over time.

f. Section 615.5133(f)(4)—Quarterly Stress Testing

Final § 615.5133(f)(4)(i) imposes requirements regarding quarterly stress testing. The technical changes we made from proposed § 615.5133(f)(2)(ii) are not material. These changes consist of clarifying the language and relocating language from proposed § 615.5133(f)(2)(iii) that is more logically located here.

¹⁵ As part of reorganizing the final rule, we relocated this requirement from proposed § 615.5133(f)(2)(iii).

One of the bank commenters agreed that a properly structured and documented quarterly stress test can provide useful information on capital, earnings, and liquidity risk relative to changes in market value of the entire portfolio, and it stated that the parameters an individual institution sets for the quarterly stress-testing analysis of its entire investment portfolio as a whole should be sufficient to analyze the level of risk contributed by investments.

We do not believe that stress testing an institution's entire portfolio as a whole is sufficient to analyze the risk of investments. It is critical to know individual results. Otherwise, risks could be offsetting each other, resulting in a portfolio-wide test that shows little risk, yet has pockets of investments that may exhibit significant risk. Accordingly, both proposed § 615.5133(f)(2)(ii) and final § 615.5133(f)(4)(i) require institutions to stress test their entire investment portfolio, including stress tests of all investments individually and stress tests of the portfolio as a whole.

Final § 615.5133(f)(4)(ii) sets forth a methodology that applies to both pre-purchase and quarterly stress testing. Except for minor technical changes, it is identical to proposed § 615.5133(f)(2)(iii).

As proposed, because all banks currently use the alternative stress test and the Council believes that they have the capability and sophistication to develop their own stress test processes, we eliminate the existing standardized stress test option.

g. Section 615.5133(f)(5)—Presale Value Verification

We redesignate existing § 615.5133(f)(3) as § 615.5133(f)(5) and change the word "security" to "investment."

6. Section 615.5133(g)—Reports to the Board of Directors

We proposed revisions to § 615.5133(g), which specifies information that management must report to the board or a board committee each quarter. Proposed § 615.5133(g)(1) retained the general quarterly reporting requirements from existing § 615.5133(g) but added to and modified them to strengthen the overall reporting requirements.

The Council and a bank commented that the board reporting requirements were exceedingly prescriptive and limiting of the board's authority to direct management, and they requested that the provisions be generalized and simply require that the board receive a

quarterly report containing information on the investment portfolio as the board deems appropriate.

With one exception that we discuss below and minor technical changes, we are finalizing all of the general quarterly reporting requirements of § 615.5133(g)(1) (redesignated as § 615.5133(g)) that we proposed. We believe this level of reporting is necessary to ensure an institution's board has the information it needs about the institution's investments. The one proposed requirement that we are not adopting in final § 615.5133(g) is that we are not requiring institutions to report on the results of their quarterly stress tests. We expect, however, that institutions will report on stress tests results that do not comply with their investment policies.

We are including in final § 615.5133(g) the reporting requirements that were contained in proposed § 615.5143(c), governing management of ineligible investments, because we believe it is more logical to have all board reporting requirements in one provision of the regulations. We make technical, but not substantive, changes to these requirements.

Proposed § 615.5133(g)(2) would have required an institution to provide immediate notification to its board of directors or to a designated board committee if its portfolio exceeded the quarterly stress-test parameters defined in its board policy. The Council expressed concern that the term "immediate" is vague, and it requested that FCA require notification to be completed "in a reasonable manner" as the board may direct.

Since exceeding a board policy's stress test parameters is not a regulatory violation, we have decided not to require board notification if this occurs. Nevertheless, we encourage each institution's board to require that it be notified of such a situation, because it could lead to serious risk exposures for the institution.

7. Investment Plan and Investment Oversight Committee

Our proposed rule recommended, but did not propose to require, that institutions develop an investment plan and an investment oversight committee. Three commenters opposed a requirement for an investment plan or investment committee, stating that institutions' current practices already achieve the purposes of the plans and committees. Because this may be true for some institutions, we do not impose these as requirements. We continue to believe, however, that each institution that maintains an investment portfolio

should consider whether it could benefit from the development of an investment plan and the establishment of an investment committee. The preamble to our proposed rule discusses the benefits of these plans and committees. We also note that the Federal Reserve published a proposed rule (77 FR 594, January 5, 2012) that would require publicly traded bank holding companies with total consolidated assets of \$10 billion or more to establish and maintain an enterprise-wide risk committee of the board of directors. Some System banks have already begun to or have implemented such committees.

D. Section 615.5135—Management of Interest Rate Risk

We are relocating the requirements of existing § 615.5135 to revised § 615.5180 in part 615 subpart G of our regulations, because we had other interest rate risk requirements in subpart G and it was logical to locate all of these requirements together. We will discuss the changes made to § 615.5180, and to other provisions in subpart G, below.

E. Section 615.5136—Emergencies Impeding Normal Access of Farm Credit Banks to Capital Markets

Final § 615.5136, which is very similar to what we proposed, provides that an emergency shall be deemed to exist whenever a financial, economic, agricultural, or national defense, or other crisis could impede the normal access of Farm Credit banks to the capital markets. Whenever the FCA determines, after consultations with the Funding Corporation to the extent practicable, that such an emergency exists, the FCA Board may, in its sole discretion, adopt a resolution that:

- Modifies the amount, qualities, and types of eligible investments that banks are authorized to hold pursuant to § 615.5132;
- Modifies or waives the liquidity requirement(s) in § 615.5134; and/or
- Authorizes other actions as deemed appropriate.

The revisions in our proposal, which we itemized in the preamble to the proposed rule, provide additional flexibility to the resolution that the FCA Board may adopt. The Council supported these revisions. The final rule adds the catch-all "other crisis" that could impede normal access to the capital markets.

F. Section 615.5140—Eligible Investments

We make only minor technical changes to this provision. We delete the

reference to divestiture in existing § 615.5140(a)(4), because we no longer require divestiture of investments that were eligible when purchased, and the treatment of investments that were ineligible when purchased is specified in § 615.5143(a). We also delete the references to stress testing mortgage securities in existing § 615.5140(a)(5), because new § 615.5133(f) sets forth stress-testing requirements for investments. Finally, we make a slight formatting change to § 615.5140(a) to clarify its requirements.

G. Section 615.5141—Stress Tests for Mortgage Securities

As proposed, we remove this stand-alone, stress-testing section from our regulations, because we have included stress-testing requirements in final § 615.5133(f)(1)(iii) and (f)(4).

H. Section 615.5143—Management of Ineligible Investments and Reservation of Authority To Require Divestiture

Existing § 615.5143 requires an institution to dispose of an investment that is ineligible¹⁶ within 6 months unless we approve, in writing, a plan that authorizes the institution to divest the instrument over a longer period of time.

New § 615.5143(b) no longer requires a System institution to divest of (or to receive approval of a divestiture plan for) an investment that was eligible when purchased but no longer satisfies the eligibility criteria.¹⁷ Rather, the institution must notify the FCA within 15 calendar days of determining that the investment no longer satisfies eligibility criteria. This approach provides institutions with greater flexibility to manage their positions and mitigate losses as compared with a forced divestiture during a specified time period. Two commenters supported this change to our overall approach.

The proposed rule would have required an institution to notify FCA "promptly" if an investment no longer satisfies the eligibility criteria. The Council commented that it was unsure what "prompt" meant in the context of the rule, and it stated that notification is redundant and unnecessary given the requirements of the regulation and the ongoing nature of the FCA's examination function. If FCA retained this requirement, the Council suggested a 60-day calendar notice.

In response to this comment, we make the notification period 15 calendar days after the System institution determines

¹⁶ Under existing § 615.5140.

¹⁷ Such an investment would no longer be considered "ineligible."

that the investment no longer satisfies the eligibility criteria. We believe this notification period is adequate, since the timeframe does not begin until the System institution makes the determination. Moreover, notification can be as simple as a telephone call or email.

In addition, in the final rule as in the proposed, the institution is subject to the following requirements:

- It must not use the investment to satisfy its liquidity requirement(s) under § 615.5134;
- It must continue to include the investment in the § 615.5132 investment portfolio limit calculation;
- It may continue to include the investment as collateral under § 615.5050 and net collateral under § 615.5301(c) at the lower of cost or market value; and
- It must develop a plan to reduce the risk arising from the investment.

The proposed rule would have required notification to FCA when an investment that satisfied the regulatory eligibility criteria was not suitable because it did not satisfy the risk tolerance established in the institution's required board policy, and the investment would have been subject to requirements regarding exclusion from the liquidity reserve, inclusion in the investment portfolio limit, inclusion in collateral and net collateral, and the development of a risk reduction plan. We are deleting this notification requirement, as well as the other requirements, from the final rule because we do not want to create a disincentive for a System institution to establish a risk tolerance that is stricter than FCA's regulatory eligibility criteria. Under the final rule, a System institution does not have to notify the FCA when an investment that satisfies FCA's regulatory eligibility criteria does not satisfy its own risk tolerance, nor is the investment subject to the other requirements.

As we proposed, final § 615.5143(a) provides that an investment that does not satisfy the regulatory eligibility criteria at the time of purchase is ineligible. Under the final rule (as under the existing regulation), System institutions may not purchase ineligible investments. If a System institution does purchase an ineligible investment, it must notify the FCA within 15 calendar days after determining that the investment was ineligible and must divest of the investment no later than 60 calendar days after the determination unless we approve, in writing, a plan that authorizes divestiture over a longer period of time. In addition, in the final

rule as in the proposed, until the institution divests of the investment:

- It must not be used to satisfy the institution's liquidity requirement(s) under § 615.5134;
- It must continue to be included in the § 615.5132 investment portfolio limit calculation; and
- It must be excluded as collateral under § 615.5050 and net collateral under § 615.5301(c).

Although it is not stated in the regulation, we clarify here than an acceptable divestiture plan would have to require a System institution to dispose of the investment as quickly as possible without substantial financial loss. The plan would also have to contain sufficient analysis to support retention of the investment, including its effect on the institution's capital, earnings, liquidity, and collateral position. Our decision would not be based solely on financial loss and would include consideration of all circumstances surrounding the purchase.

In addition, we emphasize that any purchase of an ineligible investment would indicate weaknesses in a System institution's internal controls and due diligence and would trigger increased FCA oversight if it occurs. We expect such a purchase to occur rarely, if ever. For this reason, we are retaining the divestiture requirements from the existing and proposed rules, despite the Council's and a bank commenter's request that we treat investments that are ineligible when purchased in the same manner as we treat investments that are eligible when purchased but that subsequently fail to meet the eligibility criteria. Furthermore, in response to the Council's comment that this provision essentially authorizes System institutions to purchase ineligible investments that could be held for 60 calendar days, we emphasize that this provision does not authorize such a purchase. As stated, if a System institution makes such a purchase, it should expect increased FCA oversight of its internal controls and due diligence process as well as enforcement actions as appropriate.

Proposed § 615.5143(c) would have required each institution to report to its board at least quarterly regarding investments that were ineligible when purchased and investments that were eligible when purchased but that no longer satisfy the eligibility criteria. As discussed above, we have moved these reporting requirements to § 615.5133(g) so that all board reporting requirements for investments are in one place.

Finally, § 615.5143(d) reserves FCA's authority to require an institution to

divest of any investment at any time for failure to comply with § 615.5132(a) or § 615.5142 (as applicable) or for safety and soundness purposes. Although we did not propose failure to comply with the permissible investment purposes specified in § 615.5132(a) and § 615.5142 as a basis for requiring divestiture, this change merely makes explicit our implicit authority to require divestiture of an investment that does not comply with our investment regulations. The timeframe FCA sets would consider the expected loss on the transaction (or transactions) and the effect on a System institution's financial condition and performance. Because the final rule would not require divestiture of any investment that was eligible when purchased, FCA is making express our authority to require divestiture of investments when necessary. We received no comments on our proposed reservation of authority.

I. Section 615.5174—Farmer Mac Securities

We proposed changes to § 615.5174(d), governing stress testing of Farmer Mac securities, which Farm Credit banks, associations, and service corporations are permitted to purchase and hold for the purpose of managing credit and interest rate risk and furthering their mission to finance agriculture. For the reason discussed in the preamble to the proposed rule, we proposed to remove the requirement that a System institution must subject Farmer Mac securities backed by loans that the institution originated to the stress testing applicable to investments. If a System institution purchases a Farmer Mac security from another System institution or from outside the System, however, the security would remain subject to the stress testing applicable to investments. Because we proposed to eliminate our divestiture requirement for other investments that fail a stress test, we also proposed to eliminate that divestiture requirement for those Farmer Mac securities that remain subject to stress testing.

We also added a definition of the term "you" in new § 615.5174(e), to clarify that the regulation applies to Farm Credit banks, associations, and service corporations.

We received two comments on § 615.5174, both supporting the stress-testing change, and we are finalizing § 615.5174 as proposed.

J. Section 615.5180—Bank Interest Rate Risk Management Program

We are revising § 615.5180 by moving the requirements of existing § 615.5135 and existing § 615.5181 into this

section. Since all three existing sections govern interest rate risk management of banks, it makes sense to combine them into one regulatory provision.

Interest rate risk management is an important part of the overall financial management of a Farm Credit bank. The potentially adverse effects that interest rate risk may have on net interest income and the market value of equity is of particular importance.

We believe that strong policy direction from a Farm Credit bank's board of directors is essential to an effective interest rate risk management program. Accordingly, final § 615.5180(a) retains the existing requirement, currently contained in § 615.5180, that a bank's board must develop and implement an interest rate risk management program, tailored to the needs of the institution, that establishes a risk management process that effectively identifies, measures, monitors, and controls interest rate risk. Final § 615.5180(a) also contains the requirement, currently contained in § 615.5181(a), that the bank's board of directors must be knowledgeable of the nature and level of interest rate risk taken by the institution.

Final § 615.5180(b) contains the requirement, currently in § 615.5181(b), that senior management is responsible for ensuring that interest rate risk is properly managed on both a long-range and a day-to-day basis.

Final § 615.5180(c), which requires the board of directors of each bank to adopt an interest rate risk management section of an asset/liability management policy that establishes interest rate risk exposure limits as well as the criteria to determine compliance with these limits, contains the requirements we had proposed in § 615.5135, as revised.

Final § 615.5180(c) requires, in addition to the existing requirements that carry over, that the interest rate risk management section must establish policies and procedures for the bank to:

- Address the purpose and objectives of interest rate risk management;
- Consider the effect of investments on interest rate risk based on the results of the required stress testing;¹⁸
- Identify exception parameters and approvals needed for any exceptions to the requirements of the board's policies;
 - Describe delegations of authority;
 - Describe reporting requirements, including exceptions to limits contained in the board's policies; and
- Consider the nature and purpose of derivative contracts and establish

counterparty risk thresholds and limits for derivatives.

We delete several existing requirements because similar requirements are also contained in the board reporting requirements of § 615.5133(g).

We are finalizing our proposal to require that management of each bank must report at least quarterly to its board of directors, or to a designated committee of the board, describing the nature and level of interest rate risk exposure. Any deviations from the board's policies on interest rate risk must be specifically identified in the report and approved by the board or a designated committee of the board.

The Council generally supported the proposed changes to the rule, but it was concerned that FCA would implement the additional requirements in a way that results in additional burden in areas where such burden is not supported by identified weaknesses in current System interest rate risk management practices. The Council stated that this area has functioned exceedingly well over the years, including throughout the recent financial market crisis, and it asked that FCA recognize this effectiveness.

We recognize that overall, the System has implemented effective interest rate risk management practices. We believe our revisions to this rule will further strengthen these practices. We do not intend to impose additional burden in implementation unless that burden is warranted.

K. Section 615.5181—Bank Interest Rate Risk Management Program

We remove this section from our regulations, because we have included these requirements in final § 615.5180.

L. Section 615.5182—Interest Rate Risk Management by Associations and Other Farm Credit System Institutions Other Than Banks

We made minor technical, non-substantive changes to this provision.

M. Section 615.5201—Definitions

As discussed above, our capital adequacy regulation at § 615.5201 defines the terms Government agency and Government-sponsored agency. We agree with the Council's comment that FCA's definitions should be consistent among themselves. Accordingly, we are revising the definitions in § 615.5201 to conform to the new definitions in § 615.5131.

IV. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601

et seq.), the FCA hereby certifies that the final rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the 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 in 12 CFR Part 615

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

For the reasons stated in the preamble, part 615 of chapter VI, title 12 of the Code of Federal Regulations is amended as follows:

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

- 1. 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.

- 2. Section 615.5131 is amended by:
 - a. Removing designations for paragraphs (a) through (l) and maintaining alphabetical order;
 - b. Removing the reference to "615.5131(h)" from the definition for "asset-backed securities (ABS)" and adding in its place the words "this section"; and
 - c. Adding in alphabetical order definitions for "government agency" and "government-sponsored agency" to read as follows:

§ 615.5131 Definitions.

* * * * *

Government agency means the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations are fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States Government.

Government-sponsored agency means an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the

¹⁸ Existing § 615.5135 already requires banks to include investments in their interest rate shock analysis.

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

* * * * *

■ 3. Section 615.5132 is revised to read as follows:

§ 615.5132 Investment purposes.

(a) Each Farm Credit bank may hold eligible investments, listed under § 615.5140, in an amount not to exceed 35 percent of its total outstanding loans, to comply with its liquidity requirements in § 615.5134, manage surplus short-term funds, and manage interest rate risk under § 615.5180. To comply with this calculation, the 30-day average daily balance of investments is divided by loans. Investments are calculated at amortized cost. Loans are calculated as defined in § 615.5131. For the purpose of this calculation, loans include accrued interest and do not include any allowance for loan loss adjustments. Compliance with the calculation is measured on the last day of every month.

(b) The following investments may be excluded when calculating the amount of eligible investments held by the Farm Credit bank pursuant to § 615.5132(a):

(1) Eligible investments listed under § 615.5140 that are pledged by a Farm Credit bank to meet margin requirements for derivative transactions; and

(2) Any other investments FCA determines are appropriate for exclusion.

■ 4. Section 615.5133 is revised to read as follows:

§ 615.5133 Investment management.

(a) *Responsibilities of board of directors.* Your board of directors must adopt written policies for managing your investment activities. Your board must also ensure that management complies with these policies and that appropriate internal controls are in place to prevent loss. At least annually, the board, or a designated committee of the board, must review the sufficiency of these investment policies. Any changes to the policies must be adopted by the board and be documented.

(b) *Investment policies—general requirements.* Your board's written investment policies must address the purposes and objectives of investments; risk tolerance; delegations of authority; internal controls; due diligence; and reporting requirements. Moreover, your investment policies must fully address

the extent of pre-purchase analysis that management must perform for various classes of investments. Furthermore, your investment policies must address the means for reporting, and approvals needed for, exceptions to established policies. Investment policies must be sufficiently detailed, consistent with, and appropriate for the amounts, types, and risk characteristics of your investments.

(c) *Investment policies—risk tolerance.* Your investment policies must establish risk limits for the various types, classes, and sectors of eligible investments and for the entire investment portfolio. These policies must include concentration limits to ensure prudent diversification of credit, market, and liquidity risks in the investment portfolio. Risk limits must be based on all relevant factors, including your institutional objectives, capital position, earnings, and quality and reliability of risk management systems and must take into consideration the interest rate risk management program required by § 615.5180 or § 615.5182, as applicable. Your policies must identify the types and quantity of investments that you will hold to achieve your objectives and control credit, market, liquidity, and operational risks. Each association or service corporation that holds significant investments and each bank must establish risk limits in its investment policies for these four types of risk.

(1) *Credit risk.* Investment policies must establish:

(i) *Credit quality standards, limits on counterparty risk, and risk diversification standards that limit concentrations.* Limits must be set for single or related counterparty(ies), a geographical area, industries, and asset classes or obligations with similar characteristics.

(ii) *Criteria for selecting brokers, dealers, and investment bankers (collectively, securities firms).* You must buy and sell eligible investments with more than one securities firm. As part of your review of your investment policies required under paragraph (a) of this section, your board of directors, or a designated committee of the board, must review the criteria for selecting securities firms. Any changes to the criteria must be approved by the board.

(iii) *Collateral margin requirements on repurchase agreements.* You must regularly mark the collateral to market and ensure appropriate controls are maintained over collateral held.

(2) *Market risk.* Investment policies must set market risk limits for specific

types of investments and for the investment portfolio.

(3) *Liquidity risk.* Investment policies must describe the liquidity characteristics of eligible investments that you will hold to meet your liquidity needs and other institutional objectives.

(4) *Operational risk.* Investment policies must address operational risks, including delegations of authority and internal controls in accordance with paragraphs (d) and (e) of this section.

(d) *Delegation of authority.* All delegations of authority to specified personnel or committees must state the extent of management's authority and responsibilities for investments.

(e) *Internal controls.* You must:

(1) Establish appropriate internal controls to detect and prevent loss, fraud, embezzlement, conflicts of interest, and unauthorized investments.

(2) Establish and maintain a separation of duties between personnel who supervise or execute investment transactions and personnel who supervise or engage in all other investment-related functions.

(3) Maintain records and management information systems that are appropriate for the level and complexity of your investment activities.

(4) Implement an effective internal audit program to review, at least annually, your investment management function, controls, processes, and compliance with FCA regulations. The scope of the annual review must be appropriate for the size, risk and complexity of the investment portfolio.

(f) *Due diligence—(1) Pre-purchase analysis.* (i) *Eligibility, purpose, and compliance with investment policies.* Before you purchase an investment, you must conduct sufficient due diligence to determine whether it is eligible under § 615.5140, is for an authorized purpose under § 615.5132 or § 615.5142, as applicable, and complies with your board's investment policies. You must document your assessment and the information used in your assessment. Your board must approve your decision to hold an investment that does not comply with your investment policies.

(ii) *Valuation.* Prior to purchase, you must verify the value of the investment (unless it is a new issue) with a source that is independent of the broker, dealer, counterparty or other intermediary to the transaction.

(iii) *Risk assessment.* Your assessment of each investment at the time of purchase must at a minimum include an evaluation of credit risk, liquidity risk, market risk, interest rate risk, and the underlying collateral of the investment. This assessment must be commensurate with the complexity and risk in the

investment. You must perform stress testing on any investment that is structured or that has uncertain cash flows, including all mortgage-backed securities and asset-backed securities, before you purchase it. The stress test must be commensurate with the risk and complexity of the investment and must enable you to determine that the investment does not expose your capital, earnings, or liquidity to risks that are greater than those specified in your investment policies. The stress testing must comply with the requirements in paragraph (f)(4)(ii) of this section.

(2) *Ongoing value determination.* At least monthly, you must determine the fair market value of each investment in your portfolio and the fair market value of your whole investment portfolio.

(3) *Ongoing analysis of credit risk.* You must establish and maintain processes to monitor and evaluate changes in the credit quality of each investment in your portfolio and in your whole investment portfolio on an ongoing basis.

(4) *Quarterly stress testing.* (i) You must stress test your entire investment portfolio, including stress tests of all investments individually and stress tests of the portfolio as a whole, at the end of each quarter. The stress tests must enable you to determine that your investment securities, both individually and on a portfolio-wide basis, do not expose your capital, earnings, or liquidity to risks that exceed the risk tolerance specified in your investment policies. If your portfolio risk exceeds your investment policy limits, you must develop a plan to comply with those limits.

(ii) Your stress tests must be defined in a board-approved policy and must include defined parameters for the types of securities you purchase. The stress tests must be comprehensive and appropriate for the risk profile of your institution. At a minimum, the stress tests must be able to measure the price sensitivity of investments over a range of possible interest rate/yield curve

scenarios. The methodology that you use to analyze investment securities must be appropriate for the complexity, structure, and cash flows of the investments in your portfolio. You must rely to the maximum extent practicable on verifiable information to support all your assumptions, including prepayment and interest rate volatility assumptions, when you apply your stress tests. You must document the basis for all assumptions that you use to evaluate the security and its underlying collateral. You must also document all subsequent changes in your assumptions.

(5) *Presale value verification.* Before you sell an investment, you must verify its value with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction.

(g) *Reports to the board of directors.* At least quarterly, your management must report on the following to your board of directors or a designated board committee:

(1) Plans and strategies for achieving the board's objectives for the investment portfolio;

(2) Whether the investment portfolio effectively achieves the board's objectives;

(3) The current composition, quality, and liquidity profile of the investment portfolio;

(4) The performance of each class of investments and the entire investment portfolio, including all gains and losses realized during the quarter on individual investments that you sold before maturity and why they were liquidated;

(5) Potential risk exposure to changes in market interest rates as identified through quarterly stress testing and any other factors that may affect the value of your investment holdings;

(6) How investments affect your capital, earnings, and overall financial condition;

(7) Any deviations from the board's policies (must be specifically identified);

(8) The status and performance of each investment described in § 615.5143(a) and (b) or that does not comply with your investment policies; including the expected effect of these investments on your capital, earnings, liquidity, and collateral position; and

(9) The terms and status of any required divestiture plan or risk reduction plan.

§ 615.5135 [Removed]

■ 5. Section 615.5135 is removed.

■ 6. Section 615.5136 is revised to read as follows:

§ 615.5136 Emergencies impeding normal access of Farm Credit banks to capital markets.

An emergency shall be deemed to exist whenever a financial, economic, agricultural, national defense, or other crisis could impede the normal access of Farm Credit banks to the capital markets. Whenever the Farm Credit Administration determines, after consultation with the Federal Farm Credit Banks Funding Corporation to the extent practicable, that such an emergency exists, the Farm Credit Administration Board may, in its sole discretion, adopt a resolution that:

(a) Modifies the amount, qualities, and types of eligible investments that Farm Credit banks are authorized to hold pursuant to § 615.5132 of this subpart;

(b) Modifies or waives the liquidity requirement(s) in § 615.5134 of this subpart; and/or

(c) Authorizes other actions as deemed appropriate.

■ 7. Section 615.5140 is amended by revising paragraph (a) to read as follows:

§ 615.5140 Eligible investments.

(a) You may hold only the following types of investments listed in the Investment Eligibility Criteria Table. These investments must be denominated in United States dollars.

INVESTMENT ELIGIBILITY CRITERIA TABLE

Asset class	Final maturity limit	NRSRO Credit rating	Other requirements	Investment portfolio limit
(1) Obligations of the United States. • Treasuries. • Agency securities (except mortgage securities). • Other obligations fully insured or guaranteed by the United States, its agencies, instrumentalities and corporations.	None	NA	None	None.

INVESTMENT ELIGIBILITY CRITERIA TABLE—Continued

Asset class	Final maturity limit	NRSRO Credit rating	Other requirements	Investment portfolio limit
(2) Municipal Securities:				
• General obligations	10 years	One of the highest two	None	None.
• Revenue bonds	5 years	Highest	At the time of purchase, you must document that the issue is actively traded in an established secondary market.	15%.
(3) International and Multi-lateral Development Bank Obligations.	None	None	The United States must be a voting shareholder.	None.
(4) Money Market Instruments:				
• Federal funds	1 day or continuously callable up to 100 days.	One of the two highest short-term.	None	None.
• Negotiable certificates of deposit.	1 year	One of the two highest short-term.	None	None.
• Bankers acceptances	None	One of the two highest short-term.	Issued by a depository institution.	None.
• Commercial paper	270 days	Highest short-term	None	None.
• Non-callable Term Federal funds and Euro-dollar time deposits.	100 days	Highest short-term	None	20%.
• Master notes	270 days	Highest short-term	None	20%.
• Repurchase agreements collateralized by eligible investments or marketable securities rated in the highest credit rating category by an NRSRO.	100 days	NA	None	None.
(5) Mortgage Securities:				
• Issued or guaranteed by the United States.	None	NA	None	None.
• Fannie Mae or Freddie Mac mortgage securities.	None	NA	None	50%.
• Non-Agency securities that comply 15 U.S.C. 77d(5) or 15 U.S.C. 78c(a)(41).	None	Highest	None	15%.
• Commercial mortgage-backed securities.	None	Highest	<ul style="list-style-type: none"> • Security must be backed by a minimum of 100 loans. • Loans from a single mortgagor cannot exceed 5% of the pool. • Pool must be geographically diversified pursuant to the board's policy. 	
(6) Asset-Backed Securities secured by.	None	Highest	<ul style="list-style-type: none"> • 5-year WAL for fixed rate or floating rate ABS at their contractual interest rate caps. • 7-year WAL for floating rate ABS that remain below their contractual interest rate cap. 	20%.
• Credit card receivables.				
• Automobile loans.				
• Home equity loans.				
• Wholesale automobile dealer loans.				
• Student loans.				
• Equipment loans.				
• Manufactured housing loans.				
(7) Corporate Debt Securities.	5 years	One of the two highest	Cannot be convertible to equity securities.	20%.

INVESTMENT ELIGIBILITY CRITERIA TABLE—Continued

Asset class	Final maturity limit	NRSRO Credit rating	Other requirements	Investment portfolio limit
(8) Diversified Investment Funds. Shares of an investment company registered under section 8 of the Investment Company Act of 1940.	NA	NA	The portfolio of the investment company must consist solely of eligible investments authorized by §§ 615.5140 and 615.5174. The investment company's risk and return objectives and use of derivatives must be consistent with FCA guidance and your investment policies.	None, if your shares in each investment company comprise 10% or less of your portfolio. Otherwise counts toward limit for each type of investment.

* * * * *

§ 615.5141 [Removed]

- 8. Section 615.5141 is removed.
- 9. Section 615.5143 is revised to read as follows:

§ 615.5143 Management of ineligible investments and reservation of authority to require divestiture.

(a) *Investments ineligible when purchased.* Investments that do not satisfy the eligibility criteria set forth in § 615.5140 at the time of purchase are ineligible. You must not purchase ineligible investments. If you determine that you have purchased an ineligible investment, you must notify us within 15 calendar days after the determination. You must divest of the investment no later than 60 calendar days after you determine that the investment is ineligible unless we approve, in writing, a plan that authorizes you to divest the investment over a longer period of time. Until you divest of the investment:

- (1) It must not be used to satisfy your liquidity requirement(s) under § 615.5134;
- (2) It must continue to be included in the § 615.5132 investment portfolio limit calculation; and
- (3) It must be excluded as collateral under § 615.5050 and net collateral under § 615.5301(c).

(b) *Investments that no longer satisfy eligibility criteria.* If you determine that an investment (that satisfied the eligibility criteria set forth in § 615.5140 when purchased) no longer satisfies the eligibility criteria, you may continue to hold it, subject to the following requirements:

- (1) You must notify us within 15 calendar days after such determination;
- (2) You must not use the investment to satisfy your liquidity requirement(s) under § 615.5134;
- (3) You must continue to include the investment in the § 615.5132 investment portfolio limit calculation;

(4) You may continue to include the investment as collateral under § 615.5050 and net collateral under § 615.5301(c) at the lower of cost or market value; and

(5) You must develop a plan to reduce the investment's risk to you.

(c) *Reservation of authority.* FCA retains the authority to require you to divest of any investment at any time for failure to comply with § 615.5132(a) or § 615.5142 or for safety and soundness reasons. The timeframe set by FCA will consider the expected loss on the transaction (or transactions) and the effect on your financial condition and performance.

■ 10. Section 615.5174 is amended by:

- a. Removing the reference "615.5131(f)" in paragraph (a) and adding in its place, the reference "615.5131";
- b. Revising paragraph (d); and
- c. Adding paragraph (e).

The revision and addition read as follows:

§ 615.5174 Farmer Mac securities.

* * * * *

(d) *Stress Test.* You must perform stress tests, in accordance with § 615.5133(f)(1)(iii) and § 615.5133(f)(4), on mortgage securities, issued or guaranteed by Farmer Mac, that are backed by loans that you did not originate.

(e) *You.* Means a Farm Credit bank, association, or service corporation.

■ 11. Section 615.5180 is revised to read as follows:

§ 615.5180 Bank interest rate risk management program.

(a) The board of directors of each Farm Credit bank must develop, implement, and effectively oversee an interest rate risk management program tailored to the needs of the institution. The program must establish a risk management process that effectively identifies, measures, monitors, and controls interest rate risk. The board of

directors of each Farm Credit bank must be knowledgeable of the nature and level of interest rate risk taken by the institution.

(b) Senior management is responsible for ensuring that interest rate risk is properly managed on both a long-range and a day-to-day basis.

(c) The board of directors of each Farm Credit bank must adopt an interest rate risk management section of an asset/liability management policy that establishes interest rate risk exposure limits as well as the criteria to determine compliance with these limits. At a minimum, the interest rate risk management section must establish policies and procedures for the bank to:

- (1) Address the purpose and objectives of interest rate risk management;
- (2) Identify and analyze the causes of risks within its existing balance sheet structure;
- (3) Measure the potential effect of these risks on projected earnings and market values by conducting interest rate shock tests and simulations of multiple economic scenarios at least on a quarterly basis and by considering the effect of investments on interest rate risk based on the results of the stress testing required under § 615.5133(f)(4);
- (4) Describe and implement actions needed to obtain its desired risk management objectives;
- (5) Identify exception parameters and approvals needed for any exceptions to the requirements of the board's policies;
- (6) Describe delegations of authority;
- (7) Describe reporting requirements, including exceptions to limits contained in the board's policies;
- (8) Consider the nature and purpose of derivative contracts and establish counterparty risk thresholds and limits for derivatives.

(d) At least quarterly, management of each Farm Credit bank must report to its board of directors, or a designated committee of the board, describing the nature and level of interest rate risk

exposure. Any deviations from the board's policy on interest rate risk must be specifically identified in the report and approved by the board or designated committee of the board.

§ 615.5181 [Removed]

■ 12. Section 615.5181 is removed.

■ 13. Section 615.5182 is revised to read as follows:

§ 615.5182 Interest rate risk management by associations and other Farm Credit System institutions other than banks.

Any association or other Farm Credit System institution other than Farm Credit banks, excluding the Federal Agricultural Mortgage Corporation, with interest rate risk that could lead to significant declines in net income or in the market value of capital must comply with the requirements of § 615.5180. The interest rate risk management program required under § 615.5180 must be commensurate with the level of interest rate risk of the institution.

■ 14. Section 615.5201 is amended by revising the definitions for "government agency" and "government-sponsored agency" to read as follows:

§ 615.5201 Definitions.

* * * * *

Government agency means the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations are fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States Government.

Government-sponsored agency means an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the United States Congress but whose obligations are not fully and explicitly insured or guaranteed by the full faith and credit of the United States Government, including but not limited to any Government-sponsored enterprise.

* * * * *

Dated: October 25, 2012.

Dale L. Aultman,

Secretary, Farm Credit Administration Board.

[FR Doc. 2012-26806 Filed 11-2-12; 8:45 am]

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FARM CREDIT ADMINISTRATION

12 CFR Part 652

RIN 3052-AC56

Federal Agricultural Mortgage Corporation Funding and Fiscal Affairs; Farmer Mac Investment Management

AGENCY: Farm Credit Administration.

ACTION: Final rule.

SUMMARY: The Farm Credit Administration (FCA, Agency, us, or we) issues this final rule amending our regulations governing investment management practices of the Federal Agricultural Mortgage Corporation (Farmer Mac or Corporation). This final rule will help ensure that Farmer Mac maintains safe and sound non-program investment management practices in accordance with clearly articulated board-established guidance, streamlines the process for handling investments that fail to meet the eligibility criteria after purchase, and modifies the allowable purposes of Farmer Mac's non-program investments to include investments that would complement Farmer Mac's program activities. We are also finalizing the significant reorganization of these regulations that we proposed to make the regulations easier to follow.

DATES: This regulation will be effective 30 days after publication in the **Federal Register** during which either or both Houses of Congress are in session. We will publish a notice of the effective date in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT:

Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4434;

or

Jennifer A. Cohn, Senior Counsel, Office of the General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objective

The objective of this final rule is to ensure that Farmer Mac has appropriate Board policies and operational procedures in place to manage its non-program investment portfolio safely and soundly with appropriate consideration of its public mission as a Government-sponsored enterprise (GSE). This final rule will:

- Revise the permissible purposes of non-program investments;

- Revise board policy requirements, including stress-testing requirements;
- Modify the non-program investment portfolio limit;
- Reduce the regulatory burden associated with investments that fail to meet eligibility criteria after purchase; and
- Reorganize the regulations to make them easier to follow.

II. History of Rule

On May 19, 2010, we published an Advanced Notice of Proposed Rulemaking that considered revisions to Farmer Mac's non-program investment and liquidity requirements.¹ On November 18, 2011, we published a Notice of Proposed Rulemaking (NPRM) that would have revised these non-program investment and liquidity requirements.² After considering the comments we received on the NPRM, we now plan to finalize the proposed provisions contained in the NPRM in phases.

This first phase of final regulations will substantially revise the following regulations:

- § 652.10—Investment Management
- § 652.15—Non-Program Investment Purposes and Limitation (renumbered from § 652.25)
- § 652.25—Management of Ineligible Investments and Reservation of Authority to Require Divestiture (renumbered from § 652.45)
- § 652.30—Interest Rate Risk Management (renumbered from § 652.15)
- § 652.45—Temporary Regulatory Waivers or Modifications for Extraordinary Situations (renumbered from § 652.30)

These revisions will help ensure that Farmer Mac maintains safe and sound non-program investment management practices in accordance with clearly articulated board-established guidance. They also streamline the process for handling investments that fail to meet the eligibility criteria after purchase and modify the allowable purposes of Farmer Mac's non-program investments to include investments that would complement Farmer Mac's program activities.

We are also making minor technical changes to the following provisions:

- § 652.1—Purpose
- § 652.5—Definitions
- § 652.20—Eligible Non-Program Investments (renumbered from § 652.35)

In addition, we are deleting existing § 652.40, entitled "Stress Tests for

¹ 75 FR 27951.

² 76 FR 71798.