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October 31, 1995

To: The Chief Executive Officer

All Farm Credit Banks

Federal Farm Credit Banks Funding Corporation

From: David C. Baer, Director

Office of Examination

Subject: Guidelines for Utilizing Derivative Products

This Bookletter1 sets forth the Farm Credit Administration's (FCA) views on the use and management of derivatives by Farm Credit institutions (FCIs). It also provides detailed guidance for FCIs to use as they establish or review systems for controlling risk. While this guidance is oriented for use by Farm Credit banks, any FCI engaged in the use of derivative products is expected to manage them in a safe and sound manner and will be subject to evaluation by examiners based on the attached criteria. If managerial or operational systems are found to be insufficient, the FCI may be required to modify its systems, increase capital, or take other protective actions.

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

The significant increase in the types of complex derivatives, the various conditions that affect their value, and the continually evolving derivative market present considerable risk to derivative users. Failing to understand, identify, and manage such risk can have a sudden and significant impact on an institution's financial position. Using derivatives for speculative purposes, such as placing leveraged bets on the future direction of financial markets or the purchase of structured notes2 without regard to § [615.5132](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5132.docx), Investment Purposes, increases their risk. The FCA considers any speculative use of derivatives an unsafe and unsound banking practice.

The use of financial derivative products requires special expertise, experience, and rigorous controls. The FCA expects critical management systems to be in place and should be employed commensurate with each institution's use of derivative products. FCIs using derivatives, or planning to do so in the future, should use the attached guidance in establishing or reviewing their derivative operations. Controls and management systems should be updated as new technologies are developed or changes in an FCI's activities cause current systems to become obsolete.

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

Attachment

Copy to: Chief Executive Officer

All Farm Credit Associations

All Farm Credit System Service Organizations

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

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

**GUIDELINES FOR USE OF DERIVATIVE PRODUCTS BY FARM CREDIT SYSTEM INSTITUTIONS**

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

1. FCA Investment Regulations (as they apply to derivative products);

2. FCA Regulation 12 CFR [615.5135](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5135.docx), "Management of Interest Rate Risk";

3. FCA January 15, 1991 Bookletter 281-OE, "Asset/Liability Management Practices"; and

4. FCA *Examination Manual*: Financial Module, Asset/Liability Management (ALM); Asset Module, Investments; and, Management Module, Internal Controls.

**BOARD OF DIRECTOR RESPONSIBILITIES**

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

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

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

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

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

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

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

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

**SENIOR MANAGEMENT RESPONSIBILITIES**

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

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

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

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

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

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

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

**MANAGEMENT OF RISKS ASSOCIATED WITH DERIVATIVE INSTRUMENTS**

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

**Interest Rate Risk (IRR)**

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

**Credit Risk**

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

**Legal Risk**

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

**Liquidity Risk**

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

**Operational Risk**

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

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