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November 26, 1997

To: The Chief Executive Officer

 All Farm Credit System Banks

 Federal Farm Credit Banks Funding Corporation

From: Marsha Pyle Martin

 Chairman and Chief Executive Officer

Subject: Guidance Relating to Investment Activities

The Farm Credit System (Farm Credit) banks requested that the Farm Credit Administration (FCA) provide interpretative guidance concerning provisions of the investment management regulations in subpart E of part 615 and authorize new investments pursuant to § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(11). The FCA has also received requests to revise certain provisions of the regulations so that Farm Credit banks will have greater flexibility to adapt to the continuing evolution of the financial markets.

This bookletter provides additional guidance to Farm Credit banks on the scope of their authorities under existing regulations to invest in mortgage-backed securities that are backed by mortgages that convert from a fixed-rate to an adjustable-rate, bank notes, and general obligations of State and municipal governments. In addition, this guidance provides an interpretation on whether Farm Credit banks are authorized to acquire hedge instruments that raise or remove the cap on floating-rate collateralized mortgage obligations and clarifies the liquidity reserve requirements in § [615.5134](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5134.docx).

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

**A.** **Fixed/Floating Adjustable-Rate Mortgage Securities**

Farm Credit banks are currently authorized by § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2) to invest in securities that are backed by either fixed-rate mortgages or adjustable-rate mortgages (ARMs) that satisfy certain conditions. According to § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2)(ii), eligible securities may be backed by ARMs that have repricing mechanisms of 1 year or less tied to an index.1 Additionally, fixed-rate mortgage-backed securities (MBSs) that comply with the three-pronged test in § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2)(iii) are eligible investments for Farm Credit banks.2

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

Fixed/floating ARMs are a hybrid of fixed-rate and adjustable-rate MBSs because they share common attributes with both types of securities. The FCA determines that § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2) authorizes Farm Credit banks to invest in MBSs that are collateralized by mortgages that bear a fixed-rate of interest for a specified number of years and then reprice annually. These MBSs must comply with the requirements of § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2)(iii) at the time of purchase and each quarter thereafter until the date of first repricing. Once these instruments begin to reprice every 12 months or less, they are subject to § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2)(ii), which governs adjustable-rate MBSs. This approach enables Farm Credit banks to invest in fixed/floating ARMs in a prudent manner.

**B. Applicability of Hedge Instruments to the Farm Test**

FCA regulation § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2)(iv) exempts floating-rate collateralized mortgage obligations (CMOs) from the requirements in § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2)(iii)(A) and (B) if interest rates remain below the contractual interest rate cap. Thus, floating-rate CMOs that bear interest rates below their contractual cap rate are only required to comply with the price sensitivity test in § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2)(iii)(C). The Farm Credit banks request that hedge instruments that are specifically purchased to raise or remove the cap on floating-rate CMOs should be considered along with the underlying CMOs for the purpose of determining whether the exemption in § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2)(iv) applies.

Purchasing hedge instruments that raise or remove the cap on floating-rate CMO investments is compatible with the risk management objectives of § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2)(iii). Such hedge instruments effectively counteract the risk that rates will rise above the embedded cap, thereby decreasing the price sensitivity of the floating-rate CMO to changing interest rates.3

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

1. These investment activities comply with the requirements in FCA's bookletter ([BL-023](http://ww3.fca.gov/readingrm/handbook/FCA%20Bookletters/BL-023.docx), October 31, 1995) concerning "Guidelines for Utilizing Derivative Products."

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

3. Farm Credit banks maintain documentation that the hedge transaction makes sound economic and business sense and adhere to the investment objectives and risk limits of the bank and FCA regulations. Essentially, Farm Credit banks must demonstrate that the primary purpose of a hedge is to reduce the price sensitivity of the CMO to changes in interest rates, rather than to merely qualify the investment for exemption under § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2)(iv).

**C. Investments in Bank Notes**

The FCA has reviewed § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(8), which permits investments in certain corporate debt obligations, and determines that Farm Credit banks may acquire bank notes under this provision. The FCA concludes that bank notes are compatible with the investment objectives in § [615.5132](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5132.docx). Bank notes are senior unsecured debt obligations of commercial banks. Active markets exist for both short-term bank notes that mature within 1 year and medium-term bank notes that mature within 5 years.

Bank notes are not insured deposits under section 3(l) of the Federal Deposit Insurance Act (FDIA), 12 U.S.C. 1813(l), and therefore, holders of bank notes are general creditors of the issuing bank. Bank notes are corporate debt obligations of commercial banks. For these reasons, the FCA determines that Farm Credit banks may purchase and hold bank notes pursuant to their authority under § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(8) to invest in corporate debt obligations that:

1. Maintain a credit rating of at least "AA" or its equivalent.

2. Mature within 5 years or less from the date of purchase.

3. Qualify as marketable investments pursuant to § [615.5131](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5131.docx)(j).

4. Do not convert into equity securities.

In accordance with § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(8), corporate debt obligations cannot exceed 15 percent of each Farm Credit bank’s investment portfolio. Additionally, § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(b) prohibits Farm Credit banks from investing more than 20 percent of their total capital in eligible investments of a single obligor.

When Farm Credit banks acquire bank notes that mature within 1 year or less, they may rely on the short-term ratings assigned by any nationally recognized statistical rating organization (NRSRO). For the purpose of § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(8), the FCA considers a short-term rating of "A-1" equivalent to a "AA" long-term rating.4

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

The following discussion provides Farm Credit banks with guidance relating to the scope of their authorities under §§ [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(10) and [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(11) to invest in revenue bonds that are issued by State and local governments.

For the purposes of § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(10), full faith and credit obligations are issued by a State or local government (including duly constituted governmental authorities that provide education, water and sewer, hospital, and public transportation services within a specified territory) that possesses powers of general taxation. In this context, the State or local government is obligated to repay its debt with proceeds from income, sales, or property taxes. Other sources of revenue, such as fee income for governmental services or payments from the Federal government, may provide a credit enhancement for general obligation bonds that are issued on the full faith and credit of a State or local government. Additionally, full faith and credit obligations of State and local governments are eligible investments for Farm Credit banks under § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(10) if they: (1) maintain at least a rating of "A" or its equivalent by a NRSRO; (2) mature within 10 years from the date of purchase; and (3) qualify as marketable investments under § [615.5131](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5131.docx)(j).

Revenue bonds are debt obligations of local governments that are repaid from sources of income other than tax revenue, such as fees or transfer payments from the Federal government. Revenue bonds, however, may still qualify as full faith and credit bonds under § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(10) if another obligor with general powers of taxation (including property taxation) has unconditionally promised to make funds available to cover all payments on such obligations. For example, if fee income is the only source of revenue for a governmental authority that operates public airports, its revenue bonds are not eligible investments under § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(10). However, if a State or local government which possesses general taxation powers unconditionally pledges to make funds available to cover all payments of the bonds issued by the airport authority, these debt obligations become eligible investments under § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(10). Industrial revenue bonds do not qualify as full faith and credit bonds under § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(10) because private-sector obligors, and not the governmental authority, are ultimately responsible for paying the investors.

The FCA believes revenue bonds that are not backed by general taxing powers of a governmental obligor are too diverse to be effectively covered by § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(11). For this reason, the FCA continues to explore other regulatory approaches for these revenue bonds in its rulemaking activities.

**E. Clarification of the Liquidity Reserve Requirement**

Currently, § [615.5134](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5134.docx)(b) requires each Farm Credit bank to separately identify all investments that it holds in the liquidity reserve that it maintains pursuant to § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a). In response to concerns expressed by Farm Credit banks, the FCA clarifies that the segregation requirement in § [615.5134](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5134.docx)(b) does not prevent Farm Credit banks from:

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

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

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

As the FCA interprets § [615.5134](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5134.docx)(b), a Farm Credit bank has the flexibility, at any time, to decide which instruments in its investment portfolio will be allocated to the liquidity reserve that it maintains pursuant to § [615.5134](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5134.docx)(a). Section [615.5134](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5134.docx)(a) requires each Farm Credit bank to maintain sufficient liquidity to fund its operations for a minimum of approximately 15 days. Moreover, Farm Credit banks should be mindful that § [615.5132](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5132.docx) prohibits Farm Credit banks from holding investment portfolios that exceed 30 percent of total outstanding loans, and it only allows Farm Credit banks to acquire investments for maintaining a liquidity reserve and managing short-term surplus funds and interest rate risk.

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

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

2Section [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(2)(iii), commonly known as the Farm Test, establishes a three-pronged test for eligible collateralized-mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), and fixed-rate MBSs. These instruments are eligible investments if at the time of purchase and each quarter thereafter: (1) the weighted average life (WAL) does not exceed 5 years; (2) the expected WAL does not extend for more than 2 years assuming an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points, nor shorten more than 3 years assuming an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points; and (3) the estimated change in price is not more than 10 percent assuming an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

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

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

Copy to: Chief Executive Officer

 All Farm Credit Associations

 All Farm Credit System Service Organizations