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| **Type**: | Bookletter |
| **Section Number**: | BL-052 |
| **Section Title**: | Tobacco Buyout Lending and Investment Opportunities |
| **Old/Additional ID**: | [Old/Additional ID] |

January 25, 2006

To: Chairman, Board of Directors

Chief Executive Officer

Each Farm Credit System Institution

From: Nancy C. Pellett

Chairman and Chief Executive Officer

Subject: Tobacco Buyout Lending and Investment Opportunities

On October 22, 2004, Congress enacted the “Fair and Equitable Tobacco Reform Act of 2004” (Tobacco Act) as part of the “American Jobs Creation Act of 2004.”1  The Tobacco Act repeals the Federal tobacco price support and quota programs, provides payments to tobacco “quota owners” and producers for the elimination of the quota, and provides an assessment mechanism for tobacco manufacturers and importers to pay for the buyout. Tobacco quota holders and producers will receive 10 years of equal payments under a contract with the Secretary of Agriculture. The Tobacco Act also includes a provision that allows the quota holders and producers to assign to a “financial institution” the right to receive the contract payments “so that they may obtain a lump sum or other payment.” On April 4, 2005, the United States Department of Agriculture (USDA) issued a Final Rule implementing the “Tobacco Transition Payment Program” (Tobacco Buyout).2

The Farm Credit Administration (FCA or Agency) has determined that Farm Credit System (FCS or System) institutions are “financial institutions” within the meaning of the Tobacco Act and are therefore eligible to participate in the Tobacco Buyout. FCA further recognizes that the Tobacco Buyout has significant implications for some FCS institutions and the tobacco quota holders and producers they serve. FCA believes it is essential that FCS institutions be able to provide their borrowers the option to immediately receive Tobacco Buyout contract payments and reinvest them in future business opportunities. This Bookletter explains the Agency’s position on the options available to System institutions for utilizing the Tobacco Buyout to meet their borrowers’ financial needs under both their lending and investment authorities.

**Assignments and Successor-in-Interest Contracts**

Under the USDA Final Rule, payments will be made to tobacco quota holders and producers by the Commodity Credit Corporation (CCC). The USDA Final Rule provides that tobacco quota holders and producers may assign their right to receive Tobacco Buyout contract payments to a third party (including a System institution) in two ways: (1) through an “assignment” of payments or (2) by entering into a “successor-in-interest” contract with a third party.

The following table highlights some of the differences between an assignment of payments and a successor-in-interest contract.

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| **Assignments** | **Successor-in-Interest Contracts** |
| * May be entered into at any time beginning with first payment in 2005. * May include all or part of the payments. * The tobacco quota holder or producer retains ownership of the contract and the related rights and obligations under the contract. * Are subject to administrative offset under the Debt Collection Act of 1996. * Can be revoked at any time with consent of the assignee. | * May be entered into starting with the FY 2006 payment. * Partial successor-in-interest contracts are not allowed. * The successor purchases the entire contract and all related rights and obligations associated with the contract. * If a claim is owed by the seller to the United States, the CCC will not approve the successor-in-interest contract. Therefore, the successor-in-interest contract is not subject to administrative offset. * May not be revoked. * The CCC will allow the sale of successor-in-interest contracts to another party. |

**How the System Can Utilize the Tobacco Buyout to Meet Borrower Needs**

*Option 1 - Loans*

Under the System’s lending authority, System institutions can make loans to eligible borrowers and accept Tobacco Buyout contract payments as a dedicated source of repayment and/or primary or secondary collateral for the loans. As with any loan, loans related to Tobacco Buyout contract payments should be made in accordance with prudent credit underwriting practices, and all credit factors should be considered. System institutions may adopt special underwriting standards for this program that take into account their borrowers’ financing needs and the unique nature of lending transactions related to the Tobacco Buyout.

*Option 2 – Investments*

This option includes direct assignments or successor-in-interest contracts, as well as securities created from Tobacco Buyout contract payments. The FCA considers investments related to the Tobacco Buyout an important mission-related activity because such investments can provide tobacco quota holders and producers immediate access to funds to help ease their transition away from government price support for future production and to meet their current financial needs.

The FCA has determined that investments in Tobacco Buyout instruments are comparable to and share many characteristics with other obligations of the United States, its agencies, instrumentalities, and corporations authorized under FCA regulation § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(a)(1). However, we also recognize the unique nature of the Tobacco Buyout and that it will have a significant financial impact on many tobacco quota holders and producers. Therefore, we concluded that investments in Tobacco Buyout instruments should be classified separately and treated as mission-related investment activities under § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(e) that are not subject to the 35 percent portfolio cap for System bank investments under § [615.5132](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5132.docx).

The FCA Board has approved “Tobacco Buyout instruments” as eligible investments that FCS banks, associations, and service corporations may purchase and hold under § [615.5140](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5140.docx)(e) with the following conditions:

1. “Tobacco Buyout instruments” means contracts and securities related to the Tobacco Buyout, which was established under the Tobacco Act, including:

a. Assignments of Tobacco Buyout contract payments by tobacco quota holders and producers,

b. Successor-in-interest contracts, and

c. Securities backed by Tobacco Buyout contract payments, assignments, or successor-in-interest contracts.

2. Prior to purchase, each FCS institution board must adopt written policies governing their investments in Tobacco Buyout instruments in accordance with § [615.5133](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5133.docx). Policies covering Tobacco Buyout instruments may be included in the institution’s policies covering other investments. Risk limitations and investment management should be appropriate for the nature of the institution’s investment activities. Internal valuation models may be utilized to determine the value of Tobacco Buyout instruments at purchase and sale. FCS institutions may also use their own internal models to determine the fair value of Tobacco Buyout instruments on a monthly basis.

3. FCS associations must obtain the approval of their funding bank prior to investing in Tobacco Buyout instruments.

4. Investments in Tobacco Buyout instruments must be maintained in a portfolio separate from other eligible investments so that they are readily identifiable.

**Risk Management**

Engaging in lending and investing activities related to the Tobacco Buyout may carry unique operational risks, particularly with assignment transactions. System institutions should fully understand the Tobacco Buyout regulations, contract payment procedures and requirements, and tax implications.

System institutions should ensure they have appropriate policies, procedures, and internal controls in place to effectively manage all risks associated with Tobacco Buyout lending and investing activities. System institutions should also consider developing policies to ensure that all tobacco quota holders and producers are treated fairly and equitably. All System institutions interested in investing in Tobacco Buyout instruments should establish policies that place risk limits on these investments based on their institution’s risk-bearing capacity. In addition, System associations that want to purchase Tobacco Buyout instruments can only do so in amounts approved by their funding bank. FCA will evaluate the safety and soundness of Tobacco Buyout related lending and investment activities through its ongoing examination process.

**Capital Treatment**

Tobacco Buyout contract payments are made by the CCC and have the same contractual sanctity as other CCC payments. Although the funding for Tobacco Buyout payments is primarily derived from assessments levied upon manufacturers and importers of tobacco products, CCC’s obligation is the same as for any other CCC contract.

Our May 13 Bookletter required successor-in-interest contracts to be risk-weighted at 20 percent. After our Bookletter was issued, the CCC clarified that there are no payment contingencies for Tobacco Buyout contracts. In response, the banking regulators in November changed their risk-weighting for these successor-in-interest contracts to zero percent. Because of the changes made by the CCC and the actions of the banking regulators, *the Agency has concluded that all successor-in-interest contracts, both new and existing, should be risk-weighted at zero percent.*

Assignments of Tobacco Buyout payments are not obligations of the CCC, but rather of the borrower. Typically, assignments of all kinds are taken as collateral for loans. Tobacco Buyout payments received from an assignment are subject to borrower contingencies in ways that successor-in-interest contracts are not. For instance, the borrower’s failure to pay federal income taxes may cause the association to lose all or some of the expected payments from the assignment. Our May 13 Bookletter allowed loans supported by Tobacco Buyout assignments to be risk-weighted at 20 percent. The banking regulators require loans supported by Tobacco Buyout assignments to be risk-weighted at 100 percent. *The Agency has concluded that all loans recorded on and after January 1, 2006 that are supported by Tobacco Buyout assignments should be risk-weighted at 100 percent.* However, associations have made loans secured by Tobacco Buyout assignments following our earlier guidance on risk-weighting. *The Agency has concluded that System institutions should continue to risk-weight at 20 percent all loans recorded before January 1, 2006 that are supported by Tobacco Buyout assignments.*

**REVISED CAPITAL RISK-WEIGHTS**

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| Asset Type | Recorded before Jan. 1, 2006 | Recorded Jan. 1, 2006 or later |
| Successor-in-interest contracts | 0% | 0% |
| Loans secured by assignments | 20% | 100% |

**Additional Information**

USDA has Tobacco Buyout information on their Web site at www.fsa.usda.gov/tobacco, including the tobacco transition assessment and payment regulations. USDA also plans to release supplementary Federal Register Notices and press releases to provide the public additional program details as they become available. Furthermore, it is expected that the IRS will post information on Tobacco Buyout tax implications on their Web site, including their ruling on the tax treatment for assignments and successor-in-interest contracts.

If you have questions on your permissible lending and investment activities related to the Tobacco Buyout, please contact Laurie Rea, Associate Director, Office of Regulatory Policy, at (703) 883-4232 or by email at real@FCA.gov.

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1P.L. No. 108-357 (Oct. 22, 2004).

270 Fed. Reg. 17150 (April 4, 2005).