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February 12, 2007

To: The Chief Executive Officer

The Chief Financial Officer

Each Farm Credit Bank and Association

From: Nancy C. Pellett

Chairman and Chief Executive Officer

Subject: Revised Regulatory Capital Treatment for Certain Electric Cooperatives Assets

A Farm Credit System (FCS or System) bank asked the Farm Credit Administration (FCA or Agency) to apply a lower regulatory capital risk weight to certain loans and leases to generation and transmission and electric distribution cooperatives (electric cooperatives). This request was made pursuant to FCA’s reservation of authority as defined under § [615.5210](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5210.docx)(f). Under the reservation of authority provision, if the risk weight specified in § [615.5211](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5211.docx) does not appropriately reflect the level of risk in an asset, the FCA may, on a case-by-case basis, determine the appropriate risk weight for the asset.

Upon review and analysis of the electric cooperative industry, the FCA acknowledges the unique characteristics and lower risk profile of this industry segment. This lower risk profile is supported, in part, by the financial strength and stability of the underlying member systems, the ability to establish user rates with limited third-party oversight, and the exclusive service territories encompassing rural America -- all of which insulate the electric cooperative industry from many of the credit-related risks experienced by investor-owned utilities. The strength and lower risk profile of the electric cooperative industry are further supported by its minimal loss history and sound credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs).

Based on this industry’s risk profile and our analysis, the FCA has determined that exposures to certain loans, leases, participation interests, and debt securities (Assets) of the electric cooperative industry warrant a lower regulatory capital risk weight, subject to specified conditions described herein. The revised regulatory capital treatment is specific to the electric cooperative industry. **All FCS institutions may apply the revised regulatory capital risk weight to their electric cooperative Assets as indicated in this guidance retroactive to January 1, 2007.**

**Assets Subject to Lower Regulatory Capital Risk Weight**

The Agency assigns exposures to electric cooperative Assets, subject to specified conditions prescribed below, to the 50-percent risk-weight category set forth in § [615.5211](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5211.docx)(c).

The Agency further assigns exposures to such electric cooperative Assets to the 20-percent risk-weight category set forth in § [615.5211](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5211.docx)(b), subject to the specified conditions prescribed below, if the Asset is rated in one of the two highest credit rating categories (e.g., AAA or AA) by an NRSRO. The risk weighting is based on the NRSRO credit rating of the specific Asset (issuance) and not the issuer rating. If an Asset has more than one NRSRO rating, the lowest rating determines whether this risk weighting applies.

Notwithstanding the guidance in this Bookletter, all asset- and mortgage-backed securities (even if they satisfy the conditions below) will remain subject to the current regulatory risk-based capital treatment under § [615.5211](http://ww3.fca.gov/readingrm/handbook/FCA%20Regulation/615.5211.docx).

**Conditions for Application of Lower Regulatory Capital Risk Weight**

(1) The Asset must be risk rated 1 through 7 under the System's risk-rating model. The System has adopted standard risk ratings based on a combined risk-rating model that utilizes a two-dimensional risk rating process that includes a risk rating (1-14 in which 1-9 are “Acceptable”) and a collateral-rating (Loss Given Default) measurement for each loan.

(2) Annually, the cooperative must not generate more than 20 percent of its revenues from non-core business, regardless of the risk rating or NRSRO credit rating of the Asset. This revenue test must be performed on a consolidated basis, and Assets of cooperatives that exceed this test must be risk weighted subject to the current capital regulations even if the cooperatives have no financial obligation for their controlled non-core subsidiaries.

* For generation and transmission cooperatives, non-core business is defined as any activity other than the generation and transmission of electricity and includes, but is not limited to, coal gasification and coal mining in excess of production needs for owned generation.
* For electric distribution cooperatives, non-core business is defined as any activity other than the generation, purchase, and distribution of electricity and includes, but is not limited to, such interests as gas distribution, propane sales, real estate development, and communications.

(3) For cooperatives constructing a new baseload power plant, regardless of the risk rating or NRSRO credit rating of the Asset:

* The plant must not be nuclear-powered (regardless of construction costs); and
* Construction costs must not exceed 25 percent of the cooperative's total assets. If construction costs exceed 25 percent of the cooperative’s total assets, then exposures to all the electric cooperative’s Assets held by a System institution must be risk weighted in accordance with the current regulations. (Note: Once the new baseload plant is placed in service, however, the cooperative will be eligible for this lower risk-weighting as long as the Asset meets all other conditions.)

**Any electric cooperative Asset that does not meet the above conditions will remain subject to the current regulatory capital risk weight.**

**Other Matters**

In the event that our periodic reviews or examinations indicate that a particular electric cooperative Asset imposes risks that are not commensurate with the risk weight specified in this guidance, or if risk(s) within the electric cooperative industry significantly changes, the FCA may require System institutions to change the assigned risk-weight category for the Asset or class of Assets. In addition, System institutions are required to maintain documentation evidencing compliance with the conditions above to receive the more favorable capital treatment.

We emphasize FCA continues to maintain its reservation of authority to determine the appropriate risk weight for any Asset that imposes risks not commensurate with the risk weight assigned. The regulatory capital treatment prescribed in this guidance is specific to electric cooperative Assets. This lower risk-weight category does not apply to any other industries or assets.

If you have questions on the guidance provided in this bookletter, please contact Laurie Rea, Associate Director, Office of Regulatory Policy, at (703) 883-4232 (or by email at real@FCA.gov) or Michael Anderson, Policy Analyst, Office of Regulatory Policy at (303) 696-9737, ext. 2081 (or by email at andersonm@FCA.gov).