Farm Credit Administration

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BOOKLETTER

July 9, 2024

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Bank and Association

From: Vincent G. Logan
Chairman and Chief Executive Officer

Subject: Revised capital treatment for certain rural water and wastewater facility exposures (Revised bookletter 070)

The Farm Credit Administration is issuing this revised bookletter to provide guidance to Farm Credit System (System) institutions regarding the capital treatment for certain rural water and wastewater (RWW) facility exposures. This revised bookletter continues to assign a 50% or 75% risk weight to certain RWW exposures that satisfy specified criteria. It supersedes the original version of the bookletter, which was published on November 8, 2018.

The original bookletter included a seven-year sunset provision. Since its publication, we have collected and reviewed data to determine whether the reduced risk weights remain appropriate. We also issued a rule on high-volatility commercial real estate (HVCRE) exposures, which affects the risk weight the original bookletter assigns to certain RWW construction exposures.[1]

This revised bookletter removes the sunset provision included in the original bookletter. In addition, it will continue to assign reduced risk weights to certain RWW exposures, including the 100% corporate exposure risk weight to certain RWW construction exposures, after the HVCRE rule becomes effective.

What is the justification for the reduced risk weight for RWW facilities?

RWW plays a critical role in agriculture and rural America, but its infrastructure is aging, and it can be difficult for rural communities to finance improvements. If managed appropriately, RWW exposures have a low risk profile.

[1] See "Risk-Weighting of High Volatility Commercial Real Estate Exposures," 89 Fed. Reg. 25117 (April 10, 2024), which adds FCA regulation 628.32(j), assigning a 150% risk weight to HVCRE exposures. The HVCRE exposures rule is scheduled to become effective January 1, 2025.

Under FCA regulations, RWW exposures, like all corporate exposures, are assigned a 100% risk weight. However, our reservation of authority authorizes us, if we determine that the risk weight for an exposure is not commensurate with the risks associated with the exposure, to require System institutions to assign a different risk weight to the exposure.[2] Based on our analysis of this industry, this bookletter assigns a 50% or a 75% risk weight to certain RWW exposures that satisfy specified criteria.

Water infrastructure is essential to rural industries such as farming, manufacturing, and mining, and to rural households, recreation and tourism, and other development.[3] The water infrastructure in many rural communities is aging and obsolete,[4] or nonexistent. Many small public water systems, often located in rural areas, have difficulties meeting the requirements of the Safe Drinking Water Act to provide safe drinking water to their customers.[5]

Many rural communities face difficulties in financing RWW infrastructure. In some cases, they do not have the number of users needed to share the cost of major infrastructure projects while maintaining affordable user rates. In addition, unlike larger urban communities, it can be difficult for rural communities to issue their own public bonds to pay for major improvements; in many cases, they have limited access to financial markets, restricting their ability to issue bonds to raise capital.[6] Commercial banks do not appear to be a significant source of RWW infrastructure financing. Several federal and state agencies provide grants, subsidized loans, and technical assistance to support RWW infrastructure, but the application process can be costly, time-consuming, and difficult.[7]

The System is another source of funding for RWW infrastructure, and a reduced risk weight for exposures that satisfy specified safety and soundness criteria provides more capacity for System institutions to provide this funding without taking on excessive risk. Our review of RWW exposures that the System finances confirms the overall financial strength and stability in this industry. The essential services provided by RWW facilities and the ability of many of these facilities to adjust rates as necessary help support repayment capacity, thus reducing the likelihood of default.

Which exposures are subject to a 50% or 75% capital risk weight, and which are not?

Your institution may assign a 50% or 75% risk weight to exposures to loans, leases, participation interests, and debt securities (other than asset- and mortgage-backed securities) of not-for-profit (corporate, municipal, and cooperative-owned) RWW facilities

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[2] See § 628.1(d)(3).

[3] United States Department of Agriculture, "Report to the President of the United States from the Task Force on Agriculture and Rural Prosperity," at 22–23 (October 2017).

[4] Government Accountability Office, "Rural Water Infrastructure: Federal Agencies Provide Funding but Could Increase Coordination to Help Communities," GAO-15-450T (Feb. 27, 2015, new version posted on Nov. 6, 2015), at 1.

[5] Id. at 2.

[6] Id. at 7.

[7] Id. at 1.

that operate outside cities or towns with populations of more than 20,000 residents and satisfy specified criteria.[8]

However, your institution may not assign a 50% or 75% risk weight to the following exposures; instead, these exposures should receive the 100% corporate exposure risk weight under § 628.32(f)(1) (or any successor provision):

- Exposures to similar entities.[9]
- Exposures during the initial construction or major renovation or expansion of an RWW facility, such as a treatment plant, pumping station, or storage tank, during which the facility is not fully operational. These exposures do not qualify for a 50% or 75% risk weight because of the additional risk they pose.[10] When the initial construction or major renovation has been completed and the facility is fully operational, your institution may assign a 50% or 75% risk weight. This exclusion does not apply to exposures during routine repair, upgrade, or maintenance projects that do not impede full operation of the facility; these exposures may receive a 50% or 75% risk weight if they satisfy the specified criteria.

What are the criteria for receiving a reduced risk weight?

FCA has established quantitative and qualitative criteria that an exposure to an RWW facility must meet to be assigned a reduced risk weight. Exposures must satisfy both sets of criteria to receive a reduced risk weight.

Quantitative criteria for 50% and 75% risk weights

To be eligible for a 50% risk weight, an exposure must meet the following criteria:

- The facility must demonstrate **strong and stable** repayment capacity to service all financial commitments (both principal and interest repayments) in a timely manner.
- The facility must exhibit **below average** leverage compared with industry peers.
- The facility exposure must have a **low** risk of default.

[8] Your institution may assign a reduced risk weight only to exposures to such RWW facilities that satisfy the eligibility and financing purposes provisions of section 3.7(f) of the Farm Credit Act of 1971, as amended, and FCA regulation § 613.3100(d). Among other requirements, these provisions limit financing to those facilities that operate in a rural area, which is defined as all territory of a state that is not within the outer boundary of any city or town having a population of more than 20,000 inhabitants based on the latest United States decennial census.

[9] As FCA Bookletter 067 explains, Congress established similar entity authority to provide System institutions and non-System lenders with a tool to manage risk. A similar entity is a person or entity that is not eligible for a loan from a System institution but has operations "functionally similar" to the operations of an eligible borrower. The Farm Credit Act of 1971, as amended, and FCA regulations specify limits on similar entity transactions.

[10] However, because of the unique characteristics of RWW exposures as discussed above, it would not be appropriate to assign the 150% HVCRE risk weight to RWW exposures during the initial construction or major renovation phase.

The metrics associated with the quantitative criteria for a 50% risk weight are as follows:

Ratio	Value
Debt/EBITDA[11]	≤9X
DSC[12]	≥1.40X
Debt/Total capital	≤50%

To be eligible for a 75% risk weight, an exposure must meet the following criteria:

- The facility must demonstrate **adequate and stable** repayment capacity to service all financial commitments (both principal and interest repayments) in a timely manner.
- The facility must exhibit **average** leverage compared with industry peers.
- The facility exposure must have a **low** risk of default.

The metrics associated with the quantitative criteria for a 75% risk weight are as follows:

Ratio	Value
Debt/EBITDA	≤11X
DSC	≥1.20X
Debt/Total capital	≤60%

For an exposure to be eligible for a 50% or 75% risk weight, your institution must document that the exposure meets all quantitative criteria. However, the exposure does not have to meet each specific metric. Your institution may use a holistic approach for its analysis, but it must document compensating factors that allow the exposure to meet all quantitative criteria even if the metrics are not met.

If an exposure does not meet the criteria, the exposure must be assigned a risk weight according to Part 628 of FCA regulations.

Qualitative criteria for 50% and 75% risk weights

To be eligible for either a 50% or 75% risk weight, an exposure must meet the following *qualitative* criteria:

- The borrower must demonstrate strong, experienced management.
- Industry conditions must be favorable, and the borrower must be well positioned in the industry.
- Broader macroeconomic conditions must be favorable for the borrower and the industry.

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[11] Debt to EBITDA is an operational profitability measure and a key ratio for risk-rating purposes. EBITDA stands for earnings before interest, taxes, depreciation, and amortization.

[12] Debt service coverage (DSC) is a ratio designed to measure the adequacy of cash flow to cover total debt service (both principal and interest).

RWW exposures must meet all qualitative criteria,[13] and your institution must document its compliance with these criteria, to receive the reduced risk weight.

Your institution may employ a probability of default (PD) risk rating system to determine whether an exposure may be assigned a reduced risk weight. The rating system must incorporate our quantitative and qualitative criteria, and your institution must perform due diligence to ensure the exposure satisfies these criteria. Under the System's current risk rating guidance, the criteria for a 50% risk weight generally equate to a PD-5, and the criteria for a 75% risk weight generally equate to a PD-7. If your institution applies a rating system, the system will be subject to our ongoing examination.

How might FCA's reservation of authority affect the risk weight assigned to an RWW exposure?

If our examinations indicate that an RWW exposure imposes risks that are not commensurate with the risk weight specified in this guidance, or if risks within the industry significantly change, we may require your institution to change the assigned risk weight for the exposure or class of exposures.

We maintain our reservation of authority to determine the appropriate risk weight for any exposure that imposes risks not commensurate with the risk weight assigned. The capital treatment prescribed in this guidance is specific to the RWW exposures described in this guidance. This lower risk weight does not apply to any other industries or exposures.

Whom do I contact if I have a question?

If you have questions on the guidance in this bookletter, please contact either of the following:

- Chris Wilson, Senior Financial Analyst, Office of Regulatory Policy, at (703) 883-4204 or wilsonc@fca.gov
- Jennifer Cohn, Assistant General Counsel, Office of the General Counsel, at (303) 696-0440 or cohnj@fca.gov

[13] Your institution must make this determination as often as deterioration in financial trends are noted, and at least annually, based on the most recent audited or "review quality" financial statements.