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November 8, 2018

To: Chair, Board of Directors

Chief Executive Officer

Each Farm Credit Bank and Association

From: Dallas P. Tonsager

Chairman and Chief Executive Officer

Subject: Revised Capital Treatment for Certain Rural Water and Wastewater Facility Exposures

Over the past few years the Farm Credit Administration (FCA) has been studying and analyzing rural water and wastewater (RWW) infrastructure. 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. Under FCA regulations, RWW exposures, like all corporate exposures, are assigned a 100 percent 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 Farm Credit System (System) institutions to assign a different risk-weight to the exposure.[[1]](#footnote-2) Based on our analysis of this industry, this Bookletter assigns a 50-percent or a 75-percent 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.[[2]](#footnote-3) The water infrastructure in many rural communities is aging and obsolete,[[3]](#footnote-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.[[4]](#footnote-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 and, in many cases, they have limited access to financial markets, restricting their ability to issue bonds to raise capital.[[5]](#footnote-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.[[6]](#footnote-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 would provide 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 helps support repayment capacity, thus reducing the likelihood of default.

**Exposures Subject to Lower Capital Risk-Weight**

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 that operate outside cities or towns with populations of more than 20,000 residents and that satisfy specified criteria may be assigned a reduced risk-weight.[[7]](#footnote-8)

Institutions may not assign the following exposures a reduced risk-weight using this Bookletter; instead, they must assign these exposures a risk-weight under Part 628:

* Exposures to similar entities.[[8]](#footnote-9)
* Exposures during the initial construction or major renovation or expansion of a RWW facility such as a treatment plant, pumping station, or storage tank during which the facility is not fully operational, because of the additional risk that these exposures pose. When the initial construction or major renovation has been completed and the facility is fully operational, an institution may assign a reduced 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.

**Criteria for Receiving a Reduced Risk-Weight**

FCA has established quantitative and qualitative criteria that an exposure to a RWW facility must meet to be assigned a reduced risk-weight.

*Quantitative Criteria for 50-Percent Risk-Weight*

* 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 to industry peers; and
* The facility exposure must have a low risk of default.

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

* Water and Sewer – Not-for-profit (corporate, municipal, and cooperative-owned) facilities that serve rural areas and communities of 20,000 or less.
  + Debt/EBITDA[[9]](#footnote-10) ≤ 9X
  + DSC[[10]](#footnote-11) ≥ 1.40X
  + Debt/Total Capital ≤ 50%

*Quantitative Criteria for 75-Percent Risk-Weight*

* 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 to industry peers; and
* The facility exposure must have a low risk of default.

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

* Water and Sewer – Not-for-profit (corporate, municipal, and cooperative-owned) facilities that serve rural areas and communities of 20,000 or less.
  + Debt/EBITDA ≤ 11X
  + DSC ≥ 1.20X
  + Debt/Total Capital ≤ 60%

RWW exposures must meet all quantitative criteria. An exposure does not have to meet each specific metric; an institution may use a holistic approach and must document in its analysis compensating factors that allow the exposure to meet all quantitative criteria even if the metrics are not met. If an exposure satisfies the criteria, it may receive the reduced risk-weight. 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-Percent Risk-Weight*

* Borrowers must evidence strong, experienced management.
* Industry conditions must be favorable with the borrower well positioned in the industry.
* Broader macro-economic conditions must be favorable for the borrower and the industry.

RWW exposures must meet all qualitative criteria. System institutions must document their compliance with all quantitative and qualitative criteria to receive the reduced risk-weight.[[11]](#footnote-12)

System institutions 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 institutions must perform due diligence to ensure the exposure satisfies these criteria. Under the System’s current risk rating guidance, the criteria for a 50-percent risk-weight generally equate to a PD-5 and the criteria for a 75-percent risk-weight generally equate to a PD-7. Application of a rating system will be subject to ongoing examination of FCA.

**Sunset Provision**

FCA believes it is prudent from a risk prospective to review the RWW industry risk profile and reevaluate this reduced risk-weight after data on its implementation is available. Accordingly, this Bookletter includes a seven-year sunset provision. We believe this time frame will give System institutions some certainty as they provide credit for these exposures and will give the agency time to collect and review data needed to determine whether the reduced risk-weight remains appropriate. We will provide ample notice to institutions about any future actions we may take with respect to this capital treatment.

**Reservation of Authority**

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

FCA maintains its 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.

If you have questions on the guidance in this Bookletter, please contact Chris Wilson, Senior Financial Analyst, Office of Regulatory Policy at (703) 883-4204 (or by email at [wilsonc@fca.gov](mailto:wilsonc@fca.gov)), or Jennifer Cohn, Senior Counsel, Office of the General Counsel at (303) 696-0440 (or by email at [cohnj@fca.gov](mailto:cohnj@fca.gov)).

1. See § 628.1(d)(3). [↑](#footnote-ref-2)
2. United State 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). [↑](#footnote-ref-3)
3. 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. [↑](#footnote-ref-4)
4. Id. at 2. [↑](#footnote-ref-5)
5. Id. at 7. [↑](#footnote-ref-6)
6. Id at 1. [↑](#footnote-ref-7)
7. Only exposures to such RWW facilities that are eligible for financing under and for which financing may be provided under section 3.7(f) of the Act and FCA regulation § 613.3100(d) may be assigned a reduced risk-weight. 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. [↑](#footnote-ref-8)
8. 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 (Act), and FCA regulations specify limits on similar entity transactions. [↑](#footnote-ref-9)
9. 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. [↑](#footnote-ref-10)
10. Debt Service Coverage (DSC) is a ratio designed to measure the adequacy of cash flow to cover total debt service (both principal and interest). [↑](#footnote-ref-11)
11. System institutions 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. [↑](#footnote-ref-12)