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BOOKLETTER

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To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution

From: Glen R. Smith
Board Chairman and Chief Executive Officer

Subject: Sound governance of wholesale funding and related processes (BL-074)

The Farm Credit Administration expects Farm Credit System (System) banks[1] to follow sound business practices in the governance and management of their wholesale funding and related processes.[2] This bookletter identifies some practices banks should follow in governing and managing these processes. It also identifies related topics for the boards and management of System associations to consider.

A System bank's operational and functional approach to wholesale funding and related processes can affect the allocation of profit and capital within a district, which can in turn affect the ability of district associations to meet the needs of their members. These operational practices also affect the management of liquidity and interest rate risks (IRR) within a district. They can influence operational factors like System debt issuance. Changes in these operational practices may also require enhanced disclosure.

As a result, changes in a bank's approach to providing wholesale funding can have broad implications. A bank's understanding of the interrelationships between these practices and their influence on bank risk management and association economic incentives is key to sound governance. For this reason, we expect System bank boards and management to exercise due care[3] in identifying and comprehensively addressing all factors relevant to a

[1] Farm Credit System banks include both Farm Credit Banks and the agricultural credit bank.

[2] This bookletter focuses on the functional processes and practices inherent to wholesale funding within the System and on certain related issues. It does not address broader strategic considerations such as a bank's strategies for earnings and capitalization.

[3] Bank directors have a fiduciary duty to the bank and its member-stockholders to exercise due care in the performance of their duties. See page 35 of FCA's Director's Role (PDF).

change in these operational practices,[4] and in evaluating existing practices on at least an annual basis.

In addition, because Congress established the System as a cooperative,[5] this bookletter reinforces our standing expectation for practices at System institutions to remain focused on their members,[6] with due consideration given to the interests of *all* stakeholders.

In governing these key bank functions, bank boards and management should give equal consideration to the needs of all their affiliated associations. They should build on the strong cooperative traditions that serve as the foundation of the System's business culture. While continuing to operate in a safe and sound manner, System banks should apply cooperative business practices in a manner that best serves all members and meets the System's mission as a government-sponsored enterprise.[7]

Why we are issuing this bookletter

Within the System, banks provide funding to affiliated associations, which in turn provide a variety of loan products to eligible borrowers, including farmers, ranchers, aquatic producers and harvesters, and others. This bank-association relationship is foundational to the System's ability to furnish sound, adequate, and constructive credit. Over time, the processes that shape this relationship have changed.

Historically, the wholesale funding practices in the System have been generally uniform within a given district. These practices have centralized many of the district's asset-liability management (ALM) responsibilities at the bank level. This centralized framework places the primary responsibility for structuring loan products, and for pricing and managing interest rate and liquidity risks, at the bank.

Over time, the System has evolved. Some associations have become larger and more sophisticated. In some districts, the banks now provide greater flexibility in their wholesale funding practices. Some banks offer loan products that can expose associations to IRR. In addition, some associations are assuming a greater degree of responsibility for ALM, developing and structuring their own loan products, and pricing and managing the resulting IRR. This evolution can result, and has resulted, in the use of multiple approaches to wholesale funding within a given district.

A bank that permits varied approaches to wholesale funding among its affiliated associations must govern its funding relationships appropriately in order to avoid the potential for unfairness and unintended transfers of economic benefit among institutions within the

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[4] For the purposes of this bookletter, a change in operational practices would include a change in practice affecting a specific district association or group of associations. (An association's shift to conducting its own asset-liability management would be one example of a change in operational practice.)

[5] See section 1.1 of the Farm Credit Act of 1971, as amended.

[6] FCA Policy Statement 80, Cooperative Operating Philosophy — Serving the Members of Farm Credit System Institutions (PDF), 75 FR 64728 (October 20, 2010).

[7] Id.

district.[8] In addition, because a bank's approach to wholesale funding and related processes can affect profit allocation within a district, these practices can alter the economic incentives that underpin association business strategies and long-run planning. The approach to wholesale funding also affects what loan products associations can offer, as well as how associations are able to respond to changes in market conditions and borrower demand. Unless a bank exercises due care, these factors may lead to competing interests within a district, governance concerns, and potential safety and soundness risks.

A bank's approach to wholesale funding also has a direct impact on the bank's risk exposure. Depending on a bank's approach, the interest rate and liquidity risks inherent to lending may be managed to varying degrees at either the bank or the association level, and this may vary from association to association within a district. This can affect a bank's counterparty exposure to its affiliated associations. Sound governance requires a bank to carefully consider the effects that these risks may have on numerous factors, including the bank's own risk management practices and the supervisory relationships between the bank and its affiliated associations.

We are issuing this guidance to ensure that banks adequately consider these complexities in the governance and oversight of the wholesale funding arrangements within their districts. A bank's approach to wholesale funding and related processes should be subject to sound and transparent board governance and oversight. The principles guiding the evolution of these practices should be rooted in the cooperative operating philosophies set forth in FCA Board Policy Statement 80, Cooperative Operating Philosophy — Serving the Members of Farm Credit System Institutions.

Each bank should evaluate its existing practices at least annually to ensure they continue to serve the board's primary wholesale lending objectives. It should exercise careful due diligence when making material changes to its practices, giving full and equal consideration to the costs, benefits, and other impacts to all borrowers in its district.

The following sections outline factors System banks and associations should consider in their governance and oversight of wholesale funding and related processes. We recognize that System banks use various approaches depending on the needs of their affiliated associations. However, regardless of the approach a bank takes, the guidance provided below under the "Bank considerations" section will help the bank's board and management provide effective governance.[9] We offer related guidance for the boards and management of System associations under the "Association considerations" section.

Bank considerations

The following are some, but not all, of the factors that a bank should consider in its governance and oversight of district wholesale funding arrangements and related processes.

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[8] Wholesale funding and related processes may give rise to a number of transfers of capital, as defined in § 615.5171, between a bank and its affiliated associations.

[9] The examples provided illustrate the types of issues to be evaluated; they are not intended to narrowly define the scope of application for the concepts discussed in this bookletter.

1. Funds transfer pricing (FTP)

FTP is a key driver of the bank's funding charges for associations that rely on centralized ALM.[10] Banks should have robust processes to ensure that FTP supports both bank and association risk management objectives. Banks should ensure, to the fullest extent practicable, that FTP processes result in charges that represent the true cost of hedging the interest rate and liquidity risks inherent in the assets funded.

If these risks are overpriced, funding charges can have an adverse effect on an association's lending strategies, local earnings, or competitive position in the lending market. For example, if prepayment risk is overpriced, associations relying on centralized ALM processes could be limited in their ability to compete for prepayable fixed-rate loans and to achieve acceptable returns.[11] In contrast, underpricing these risks can result in misleading incentives for association product selection and portfolio composition, insufficient bank pricing for longer-term loans, and excessive bank exposure to loans with higher interest rate and liquidity risks, all of which can present a safety and soundness risk to the bank.

Banks should strive for processes that neither overcharge nor undercharge associations for interest rate and liquidity risks managed at the bank on their behalf. Additional considerations include the following.

FTP assumptions
In a centralized ALM environment, banks and associations should partner as much as possible to improve the precision of key FTP assumptions. For example, FTP rates for prepayable fixed rate assets are highly dependent on loan prepayment assumptions and the forecasted mix of funding necessary to hedge both prepayment and extension risks. Coordination between a bank and its affiliated associations, including the exchange of relevant data on borrower prepayment activity, can help provide robust support for the development of these key bank assumptions. Banks should evaluate whether sufficient processes are in place to support strong coordination.

Bank FTP processes should also be responsive to material changes in market conditions. For example, a shift in monetary policy or the interest rate environment in response to systemic stress events may cause significant changes in borrower behaviors, which may cause FTP assumptions to no longer be appropriate. Such market changes may also affect the types and mix of funding required to hedge interest rate and liquidity exposures. Changes in the funding mix may also need to be incorporated into revised FTP assumptions.

FTP governance
To govern FTP properly, a bank should apply a consistent and transparent framework. It should review its assumptions and methodologies at least annually. And it should regularly

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[10] We have defined FTP as it relates to wholesale funding in FCA Bookletter 072, Interest Rate Risk Management (PDF) (January 9, 2020). The bookletter also explains the significance of a bank's FTP processes to overall IRR management. We further discuss sound principles of FTP in Exam Manual section 41.2 – Earnings Management (PDF).

[11] While associations can be compensated for some imprecision in FTP processes through patronage returns, significant imprecision can still adversely affect an association's business strategies and incentives. In districts where multiple approaches to wholesale funding may be used, a bank's ability to compensate for FTP imprecision through patronage depends, in part, on the granularity of the patronage pooling. See the section on bank patronage practices in this bookletter.

engage with a broad range of stakeholders, including all associations affected by the resulting funding charges.[12] Any time a change occurs to a bank's ALM structure or scope of activities, such as a change to the wholesale funding framework, the bank should review its FTP program, assumptions, and methodologies. The bank should also incorporate its FTP model into its broader model risk management framework.[13]

2. *Bank patronage practices*

Adjustments to wholesale funding arrangements may change association contributions to bank revenues. In such instances, the bank should reevaluate its patronage practices to ensure that it continues to comply with FCA regulatory requirements[14] and avoids unintended transfers of economic benefits between institutions.[15]

For example, bank treasury revenues may increase when actual funding costs are less than the funding charges determined by the FTP process and paid by the associations using the bank's ALM services.[16] Banks can use patronage refunds to return a portion of these revenues to associations and compensate for any imprecision in the FTP process. Associations that manage their own ALM do not use the bank's FTP process and do not contribute to such bank revenues.

Patronage processes that do not distinguish between these two funding approaches may compromise a bank's ability to use patronage as a mechanism to offset FTP inaccuracies. In these circumstances, banks should consider whether establishing separate earnings pools for related bank revenues may be warranted.

3. *Loan product offerings*

Banks should review wholesale product offerings at least annually to ensure they continue to meet the needs of associations and their borrowers. To support efficient processes, banks providing ALM to affiliated associations offer a limited suite of loan products. These bank products directly affect the products associations can offer to their retail customers, and the products that associations can offer customers in turn affect the associations' presence and competitiveness in the local lending market.[17] A bank can enhance its ability to meet

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[12] For example, see Interagency Guidance on Funds Transfer Pricing Related to Funding and Contingent Liquidity Risks (PDF) (March 1, 2016) on the website of the Board of Governors of the Federal Reserve System.

[13] We provide guidance on sound model risk management practices in section 31.1 of the Examination Manual (PDF).

[14] See § 615.5230. Our regulations require patronage refunds to be paid in accordance with cooperative principles on an equitable and nondiscriminatory basis as determined by the board of directors and in accordance with capitalization bylaws.

[15] Patronage practices that do not conform to the requirements of § 615.5230(c)(3) may also give rise to a "preferential transfer of capital" under regulation § 615.5171. Regulation § 615.5171 requires a bank board to complete specified analysis of the contemplated transfer and to notify the bank's shareholders and FCA's chief examiner before making a preferential transfer.

[16] In some instances, the funding charges that were passed to associations through the FTP process may not be sufficient to fully cover the bank's realized funding costs. For example, if loan prepayments are lower than assumed, a bank's realized funding costs may exceed those projected by the FTP process because of the under hedging of extension risk.

[17] The local lending market may include other System associations using different funding methodologies.

association borrower demand by regularly reviewing its product offerings with its affiliated associations.

Banks should also have processes to ensure that associations understand all the risks presented by the FTP options the banks offer. For example, some districts may offer funding at a reduced rate if an association agrees to assume a certain level of IRR. While low risk in most interest rate environments, these funding alternatives may present increased exposure to association earnings or limit an association's ability to respond to borrower demand in more volatile market conditions. Where a bank offers such products, it should have processes to ensure that associations understand how these products will function under all market conditions and can measure and manage their risk exposure.

4. Cost allocations in wholesale pricing

Some changes in wholesale lending arrangements may prompt banks to reevaluate the allocation of related bank operating costs. Following are some of the questions banks should consider when reevaluating cost allocations:

- Which of the bank's costs related to the wholesale funding framework are fixed and unchanged by any shift in wholesale funding arrangements?
- To what extent are the ALM and FTP resources that are used in the wholesale framework also used to support other bank functions?[18]
- What are the incremental costs of additional bank processes to supervise associations that have higher or more complex IRR risk exposures?[19]

Banks should consider these factors in totality to ensure that each association bears its fair share of related bank expenses.[20] We expect any differentiation in bank spread based on a change in wholesale funding practices to be fully justified and supported by a thorough analysis of all relevant factors. In all cases, a bank's processes should be sufficiently transparent to ensure that associations understand the basis for, and effect of, bank cost allocation methodologies and related assumptions.

5. Bank risk assessment

FCA regulations require bank boards and management to have an accurate assessment of the bank's risk profile.[21] Changes in the wholesale funding approach may change the risk presented by wholesale lending. For example, some processes may reduce the bank's direct exposure to IRR while increasing its counterparty credit risk. Because of the creditor-debtor relationship between a bank and an affiliated association, counterparty credit risk to the

[18] For example, resources are required for managing a bank's liquidity and for managing IRR resulting from owned funds, the bank's investment portfolio, and other retail assets. These processes benefit all bank wholesale customers and may use many of the same resources as the bank's wholesale funding process.

[19] See the section on bank supervisory responsibilities in this bookletter.

[20] Regulation § 615.5230(c)(3) requires each institution to establish earnings pools for the payment of patronage on a rational and equitable basis to ensure that all patrons of the institution bear their fair share of the institution's expenses.

[21] See FCA regulations §§ 628.10(e)(2) and 615.5200(c).

bank may increase as more interest rate and operational risks are managed at the association.

For sound governance of related bank processes and strategies, and for the development of appropriate bank control structures, it is essential for each bank to have a clear and documented understanding of the effects its wholesale lending practices may have on its risk profile.

6. Bank supervisory responsibilities

Each System bank has a statutory supervisory responsibility to ensure that the operations of associations within its district do not present an undue exposure to the bank, other district institutions, or the System as a whole.[22] Where a bank's wholesale funding framework allows for increased funding flexibility, the bank should ensure that wholesale lending controls, including general financing agreements, appropriately limit interest rate and liquidity risks created at individual associations and promote sound association ALM practices consistent with those outlined in FCA guidance.[23] For example, FCA Bookletter 072, Interest Rate Risk Management, outlines a number of regulatory requirements and sound business practices that address the following topics:

- ALM governance and oversight
- The development of policies and procedures
- The establishment of IRR management strategies and measurement processes
- The implementation of internal controls
- The provision of adequate staffing

Bank processes should address these and other relevant considerations before a bank allows an association to assume greater responsibility for managing and pricing its own IRR.

Banks should also ensure that adequate bank staff resources and procedures are in place to monitor and understand association risk exposures and risk management capabilities. Where a bank's controls over an association's IRR exposure rely on the association's reported IRR measures, we expect the bank to have processes in place to ensure the bank's understanding of the following:

- Key association risk measurement processes and assumptions
- Association model risk management capabilities
- Key balance sheet strategies, including those resulting in exposures not captured by reported risk measures

[22] The supervisory relationship between a System bank and its affiliated associations is defined in sections 1.5, 2.2, and 2.12 of the Farm Credit Act.

[23] FCA addresses sound ALM practices in numerous guidance documents, including BL-072, Interest Rate Risk Management (PDF); BL-062, Evaluating Strategies and Risks for Loan Pricing and Structure; BL-023, Guidelines for Utilizing Derivative Products; Exam Manual Sections 21.3 – Investments (PDF), 31.1 – Corporate Governance (PDF), 41.2 – Earnings Management (PDF), 51.2 – Liquidity Management (PDF), 61.2 – Interest Rate Risk Management (PDF), and 61.3 – Derivatives (PDF).

7. Disclosure responsibilities

Banks should review FCA's disclosure requirements and ensure that shareholder reports and Systemwide information statements accurately reflect wholesale funding arrangements and their impacts on IRR management. These documents provide potential and existing shareholders with necessary information and support the sale of debt and equity instruments in the capital markets. Their accuracy is essential.

Bank disclosures

FCA regulations include numerous requirements for disclosures in the shareholder reports of System banks, and these disclosures may be affected by a change in wholesale funding arrangements.[24] Even if there have been no changes in wholesale funding and related processes, banks should review these disclosures annually to ensure that they remain accurate.

Systemwide disclosures

FCA regulation § 630.20(g)(3)(iv) requires the Federal Farm Credit Banks Funding Corporation (Funding Corporation) to provide System investors with an overview of the System's ALM practices. Banks should coordinate with the Funding Corporation in evaluating how any changes in wholesale funding arrangements and their impacts on System ALM practices should be captured in these Systemwide disclosures.

8. Intra-district coordination

Some wholesale funding arrangements may increase the need for management coordination between a bank and its affiliated associations. For example, associations managing their own ALM determine their own funding needs and must coordinate with the bank to obtain the funds needed to support lending and operations.[25] Banks should implement sound processes and controls to ensure that district funding needs are met in an efficient and cost-effective manner.

In addition, under FCA regulation § 615.5134(f), System banks are required to maintain a contingency funding plan to ensure that sources of liquidity are sufficient to fund normal operations under a variety of stress events. Banks also must establish executable action plans to carry out their contingency funding plans. They should ensure that their

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[24] Regulation § 620.5(a)(4) requires System banks to discuss any significant developments that could have a material impact on bank earnings, interest rates to borrowers, patronage, or dividends, among other factors. Regulation § 620.5(a)(6) requires a disclosure of any material change over the past fiscal year in the manner of conducting business; for a wholesale funding bank, we would consider a change in wholesale funding arrangements affecting a majority of wholesale volume as a material change in the manner of conducting business. Regulation § 620.5(a)(10)(iv) requires associations to disclose the extent to which the district bank assumes the association's exposure to IRR; this relationship can change when wholesale funding arrangements change. Regulation § 620.5(g)(3)(iii) requires general disclosures concerning an institution's interest rate programs and its ability to control interest rate margins. These factors may also be affected at both the bank and association level because of a change in wholesale funding arrangements. Lastly, table 10 in regulation § 628.63 requires a discussion of the nature of IRR arising from non-trading activities.

[25] System banks, acting through the Funding Corporation, have the primary responsibility for obtaining funds for the lending operations of System institutions. See FCA regulation § 615.5000(a). Also see section 4.2(b) through (d) of the Farm Credit Act.

contingency funding plans and related action plans adequately consider the need for increased coordination with associations that manage their own ALM.

9. Board education

As discussed in this bookletter, a bank's wholesale funding arrangements may affect numerous factors, including the following:

- Profit allocation within a district
- Asset-liability management practices and strategies
- Funds transfer pricing
- Wholesale patronage practices
- Wholesale lending controls
- Cost accounting processes
- Disclosure requirements
- Processes for System debt issuance

Given the range and complexity of these factors, bank boards may need training to be able to provide informed oversight and governance of wholesale funding and related processes. Bank boards should consider their education needs in these areas when they perform their annual self-evaluation — particularly if material changes in practice are likely to occur soon.[26] They should receive training before committing significant district resources to changes in practice.

10.Board policy and management procedures

Bank policies and procedures should determine the objectives of the district's wholesale funding arrangements and provide an adequate framework to guide related board and management decisions. A bank's wholesale funding objectives will depend on the board's perspective of the bank's role in district operations, but following are some examples of potential objectives:

- Implementing processes that support the risk management objectives of both the bank and its associations when determining funding charges in wholesale loan rates
- Insulating district associations from interest rate and liquidity risks as much as possible or, alternatively, ensuring that controls and risk management capabilities are commensurate with the types and levels of IRR managed at district associations
- Providing flexibility in products or processes to help district associations meet market demands
- Ensuring equitability among a district's alternative funding approaches when establishing FTP rates and patronage pools or when allocating bank costs[27]

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[26] Regulation § 618.8440(b)(2) requires boards to complete an annual self-evaluation as part of the business planning process. We provide guidance on sound self-evaluation practices in Exam Manual section 31.1 (PDF) and in the Frequently Asked Questions about the 2006 changes in FCA's governance rules.

[27] See FCA regulation § 615.5230(c).

As we've discussed in this bookletter, districts use several interrelated processes to implement their wholesale funding arrangements. Banks should ensure that the policies and procedures covering these areas are consistent with the board's broader wholesale funding objectives. A list of related areas covered by policy or procedures might include but are not limited to the following:

- Wholesale credit[28]
- Loan pricing or interest rate plans
- Asset-liability management
- Liquidity risk management
- Enterprise risk management
- Strategic and operational planning
- Patronage
- Funds transfer pricing

Bank boards should establish mechanisms to ensure that bank processes are achieving wholesale funding objectives. At a minimum, they should annually review key processes and reach out to key stakeholders (particularly the bank's affiliated associations).

Association considerations

Associations that want to make changes to their wholesale funding approach, including those contemplating managing their own ALM, should consider many of the same factors discussed above, as applicable. Association boards and management should complete thorough analyses of the costs, benefits, advantages, and disadvantages of such changes, giving full consideration to the needs of all stakeholders. Just like System banks, System associations should make choices that are rooted in the cooperative operating philosophies set forth in FCA Board Policy Statement 80.

Associations that assume additional responsibility for pricing and managing their own interest rate risks should ensure that their risk management practices are appropriate for the level of risk being managed, consistent with the guidance provided in our bookletter on IRR management. We expect associations to recognize their bank's supervisory authority and to ensure that their interest rate risks, and the processes to measure and manage those risks, are clear and transparent.

Conclusion

The System exists to improve the income and well-being of all its member-borrowers by providing sound, adequate, and constructive credit and related services.[29] The bank-association relationship is the foundation of the System's ability to comply with this congressional mandate. This relationship may continue to evolve to meet the needs and challenges of borrowers in rural America. Given the broad implications of a bank's approach to wholesale funding arrangements and related processes for a district's associations and

[28] System banks are required to have a policy governing the extension of credit to direct-lender associations and other financing institutions. See regulation § 614.4120.

[29] See section 1.1 of the Farm Credit Act.

their borrowers, sound and transparent governance of wholesale funding practices is imperative.

As banks and associations contemplate changes in wholesale funding arrangements or complete reviews of existing practices, we expect boards and management to exercise sound due diligence. This would include assessing the costs and benefits to all borrowers and stakeholders to ensure that any changes in practice remain member focused and adequately considering the interests of each district institution and association borrower. A bank's failure to exercise due care in the oversight and governance of all district wholesale funding arrangements and related processes could result in governance concerns that present a safety and soundness risk.

If you have questions about this bookletter, please contact any of the following:

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