Module: Finance
Section: Funding and Debt Management
EM-435

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Introduction

This Examination Manual section constitutes the Farm Credit Administration's (FCA or Agency) guidance for examining the funding and debt management practices of Farm Credit System (System or FCS) institutions. The System is a nationwide network of non-depository lending institutions and affiliated service entities that lend to agricultural and rural America. As such, the System is dependent on the sale of debt instruments (primarily discount notes and bonds) to fund its operations. Because of the importance of debt management decisions and the impact that an institution's cost of funds has on its ability to competitively function, an examination of the impact of the structure and characteristics of its funding and debt management practices is needed.

Examination Objectives

The risks and rewards of various funding alternatives must be balanced with the financial objectives established by the institution's board of directors. Management's funding decisions should focus on managing interest rate risk, reducing interest expense, improving liquidity, and achieving earnings and capital targets. As examiners, our task is to evaluate how well management prioritizes and balances these potentially conflicting objectives. Completion of the following examination objectives should provide evidence of the effectiveness of the institution's board and management in funding and debt management decisions.

- Determine the adequacy of policy guidance and board reporting regarding funding and debt management.
- Determine the effectiveness of management's funding and debt management decisions to achieve business plan goals and maintain a reasonable interest rate risk exposure.
- Evaluate the effectiveness of management's system of internal controls to mitigate potential risks in funding and debt management.
- Determine the reliability and timeliness of management information systems regarding funding.
- Evaluate the institution's compliance with FCA regulations pertaining to funding and debt management.

Examination Criteria

Criteria for evaluating funding and debt management include:

Farm Credit Act of 1971, as amended (the Act): Sections 1.5(10), 3.1(10), 4.2, 4.3, 4.9, and 5.17(a)(4) of the Act, as amended, authorize the issuance of debt securities and set forth the responsibilities of the banks, the Federal Farm Credit Banks Funding Corporation (Funding Corporation), and the FCA in the debt issuance process. As cited in Statutes 12 U.S.C. 2153 sec. 4.2 (b)-(d), the FCA is empowered with the responsibility to approve the issuance of System debt obligations. Under 12 U.S.C. 2277a-10a(b), funding approval requests from institutions that do not comply with the minimum level for any capital requirement (i.e., permanent capital ratio, total surplus ratio, core surplus ratio, and/or net collateral ratio) or capital directive established by the FCA require prior consultation with the Farm Credit System Insurance Corporation (FCSIC).

FCA Regulations: Subparts B and C of part 615 of the FCA Regulations relate to funding expectations. Additionally, FCA Regulation 12 CFR 615.5502 of subpart P allows the Funding Corporation to issue global debt securities, dollar or non-dollar denominated, through a global agent or agents by negotiation, offer, bid, or syndicate sale and deliver such obligations by book entry, wire transfer, or such other means as may be appropriate.

FCA Bookletters:	BL-036	FCA's Approval Requirements for Global Debt
	BL-030	Voluntary Advance Conditional Payment Program
	BL-011	Farm Credit Investment Bonds

Although FCA has the authority to deny an FCS institution's access to the capital markets, such a denial could have significant adverse consequences on that institution to continue operations and could potentially increase the funding costs for the entire System. To mitigate the adverse impact of such a denial, the ongoing examination process should focus on those areas that potentially threaten future access to funding. Furthermore, the examination should identify preemptive corrective actions to avoid a potential liquidity crisis and ensure continued access to funding.

Types of Funding Instruments

FCS banks issue several types of debt instruments through the Funding Corporation. Debt instruments currently utilized by the System include:

- Bonds
  - Scheduled (calendar) bond sales
  - Unscheduled (negotiated) bond sales
  - Designated bond sales
  - Farm Credit (FC) investment bonds
  - Linked-deposit programs
- Discount Notes
- Medium-Term Notes
- Global Debt (both dollar denominated and foreign currency denominated debt)
- Repurchase Agreements
- Master Notes
- Short-term Lines of Credit
- Federal Funds Purchased
- Trust Accounts (e.g., Voluntary Advance Conditional Payments or Future Payment Funds)

The System's primary funding vehicles have historically included bonds, discount notes, and medium-term notes. Although System institutions utilize numerous other debt instruments, the combined impact of the other funding instruments is negligible. System debt securities do not carry an "explicit" guarantee by the full faith and credit of the U.S. Government; however, many investors view previous actions as a precedent for future interventions, if needed. This has supported the notion of an "implicit" guarantee. Thus, Systemwide debt securities have enjoyed a "AAA" credit rating by all major rating services because of:

- Previous Government actions to support the Farm Credit System;
- The presence of the FCA as an independent, arm's-length regulator.;
- The establishment of the FCSIC to guarantee the timely payment of principal and interest on insured debt obligations; and

- The perceived quality of other Government-sponsored enterprise (GSE) debt obligations.

Bonds: Bonds were the original source of funding for System banks. Bonds are issued in maturities from 3 months to 30 years and may have some simple structured features, such as callable or floating rate. The System issues bonds on a scheduled and unscheduled basis. Scheduled sales, also referred to as calendar bond sales, occur monthly and are sold through a member bond selling group comprised of bond dealers. Unscheduled sales occur as individual System banks need funds and are normally underwritten with one selling group member. Designated Bond sales were initiated in 1999 to improve the secondary market liquidity of Systemwide debt obligations and replace Medium-Term Notes. Secondary market liquidity was to be enhanced by increasing the size of regular (i.e., quarterly) bond sales and simplifying bond structure (i.e., term and rate structure).

Farm Credit investment bonds are debt issues of individual banks and represent a negligible amount of total funding (see FCA Bookletter BL-011 for information on authorization for these debt issues). This is in contrast to the more typical bonds issued through the Funding Corporation that represent the joint and several liability of the entire Farm Credit System. While these individual bank securities do not provide the System's joint and several liability, investment bonds have priority over Systemwide debt obligations in the event of a bank liquidation. Effectively, if the Farm Credit Insurance Fund is adequate to guarantee the timely payment of principal and interest of all insured Systemwide obligations, purchasers of FC investment bonds are assured a return of their investment.

In accordance with FCA regulations, eligibility to purchase FC investment bonds is limited to:

- Members and employees of the FCS banks and associations (except any bank officers, directors, or employees who are involved in setting the term or rate);
- Retired employees who are beneficiaries of a pension or retirement program of the FCS banks or associations; and
- Retired employees of the Farm Credit Administration.

The FCS also obtains a limited amount of funding from special loan programs administered by various states commonly known as linked-deposit programs. Linked-deposit loan programs often provide a limited amount of funding for individual borrowers who meet established criteria. Often times, such programs result in lower interest rate loans to borrowers that qualify.

Discount Notes: Discount Notes (DNs) have been a funding source to the System banks since the late 1970s. The DN program provides banks a source for short-term funding on a daily basis. Although DNs can have maturities ranging from 1 to 365 days, most issues range from overnight to 90 days. DNs are sold on a discounted basis, which means that all interest is paid at maturity. The easy availability of overnight DNs provides a great mechanism for cash management and gives institutions access to the short end of the yield curve. Short-term DNs also give banks flexibility on issuance timing and maturity.

Medium-Term Notes: Medium-Term Notes (MTNs) were originally issued by the System in 1989 and as a result of the Designated Bond Program, ceased to be issued after July 1, 1999. MTNs were issued with maturities ranging from 1 to 30 years and were issued with bullet maturities or maturities that incorporated complex structured features such as indexed-amortizing, multiple step-ups, callable in whole or partial, floating-rate, zero-coupon, or combinations thereof. Debt securities with the same characteristics will be sold in the future, but as bonds not as MTNs.

Global Debt: Global debt is a generic marketing name given debt issues targeted toward overseas investors and traded simultaneously in all of the world's large financial centers. In August 1996, the FCA Board approved the Funding Corporation's request to establish a global debt program (GDP). Under the GDP, the Funding Corporation may issue up to $5 billion in global debt in either U.S. dollars or foreign currencies.

Repurchase Agreements or Repos: A repurchase agreement or repo involves the sale of a security to a counterparty with an agreement to repurchase it at a fixed price on an established future date. Accordingly, repos represent a short-term source of funding. At initiation of the transaction, the buyer or investor pays the principal amount to the seller, and the security is transferred to the possession of the buyer. At expiration of the repo, the principal amount is returned to the initial buyer *(or lender/investor)* and possession of the security reverts to the initial seller *(or borrower).* Importantly, the security serves as collateral against the obligation of the borrower and does not actually become the property of the lender. Given the short term of a typical repo and the need to make proper custody arrangements for the securities involved, operational issues are important for proper management of repo activities.

Master Notes: Master note agreements are floating-rate short-term borrowing arrangements made directly with institutional investors (e.g., commercial banks, investment banks, mutual funds, etc.). The agreements permit institutional investors to increase or decrease the outstanding balance on a daily basis within specific limits. This funding instrument is executed directly between a System bank and an investor. Because of the lack of dealer sales commissions, the bank realizes basis points savings compared to the use of discount notes. Most master notes have annual maturities and generally roll over for another year unless terminated by either party. The FCA individually approves the master note agreements.

Short-term Lines of Credit: Short-term lines of credit are often established as a contingency, but because of the potentially higher and more volatile cost it is not a preferred source of funding. Bank lines of credit may require commitment fees and contain restrictive covenants to protect the lender in the event of borrower financial adversity. Similar to repurchase agreements, a line of credit may be collateralized by marketable investments that must be removed when calculating the institution's net collateral ratio. Short-term lines of credit are appropriate for unforeseen loan demand or other unusual cash needs. However, continual borrowing is deemed an inappropriate substitute for adequate planning of bank funding needs.

Federal Funds Purchased: In the past, System banks have obtained funds at the Federal (Fed) Funds rate. The Fed Funds market represents the borrowing and lending among various financial institutions. Technically, Fed Funds can only be borrowed by those depository institutions that are required by the Monetary Control Act of 1980 to hold reserves with Federal Reserve Banks (i.e., commercial banks, savings banks, savings and loan associations, and credit unions). However, System institutions and other GSEs have enjoyed access to this market through correspondent commercial banking relationships. The term or maturity of Fed Funds extends from overnight to a number of days. These transactions generally occur without a formal written contract, which is a unique feature of Fed Funds.

Trust Accounts (Voluntary Advance Conditional Payments (VACP) or Future Payment Funds): The use of trust accounts changed in recent years. While trust accounts typically comprise a negligible portion of institution contra-assets or liabilities, this issue periodically becomes a sensitive, high-profile focus area for various external parties. Historically, use of trust accounts centered on control of loan proceeds and providing a specific customer service. Funds were held in trust for later disbursement to control risk in certain situations. For example, insurance loss proceeds were held in trust until repairs were completed or applied to the outstanding loan balance. In addition, System institutions hold borrower VACPs or Future Payment Funds trust accounts as a customer service, primarily to fund subsequent loan payments. This essentially provides cash management services to members and also reduces a borrower's net interest expense because interest is paid on VACP accounts.

Some banks and associations aggressively market VACPs or a similar service and pay slightly above market rates compared to similar short-term instruments at depository institutions. Extensive use of VACPs could pose significant liquidity risk to an institution. Such risk could be compared to deposit runoff at a commercial bank or thrift institution. FCA Bookletter BL-030 provides guidance to System institutions regarding the establishment of policies, procedures and practices to control potential risk. Policies should require signed borrower agreements that address:

- The fact that VACP funds are uninsured
- The risk in the event of liquidation of the institution;

- Limits on amounts that can be paid into VACPs;
- Interest rates that will be paid, including the terms of variable interest rates; and
- Withdrawal guidelines or restrictions.

While VACPs typically account for a very minor portion of the institution's balance sheet, this potentially sensitive funding vehicle warrants continued examination attention. Accordingly, examination work should focus on the interest rate paid and compliance with regulations and Agency guidance.

Funding and Debt Management Expectations

Funding strategies should be designed to reduce interest rate expenses, manage interest rate risk exposures, improve liquidity, and help meet the board's earnings and capitalization objectives. Funding strategies need to be communicated, updated, and understood by senior management and the board of directors.

Board of Directors: The board must understand the primary debt management risks facing their institutions; prescribe goals; set reasonable tolerance levels; and ensure that senior management takes the steps necessary to identify, measure, monitor, and control risks. The board also needs to ensure that senior management properly monitors the effectiveness of internal control systems to ensure that all areas of the institution are in compliance with applicable policies and procedures.

Debt management decisions must be viewed in a broad context because of the interrelationships that exist between funding and almost all other aspects of the institution's operations. For example, debt needs must be matched to applicable investment transactions; derivative positions are often implemented through debt sales; loan pricing decisions are predicated on the manner in which given lending programs are funded; and, an institution's cost of debt may dictate whether it meets its earnings objectives in a given year. As such, board decisions regarding funding can and do impact the institution's entire interest rate risk profile. In accordance with FCA Regulation 12 CFR 615.5200, the board must consider various issues when assessing its total capital needs. These include any risk-oriented activities, such as funding and interest rate risks, potential obligations under joint and several liability, contingent and off-balance sheet liabilities, or other conditions warranting additional capital. Examiners should determine whether the board has considered these issues when establishing the institution's capital needs. Also, examiners must assess the existence and appropriateness of any key business plan goals established by the board impacting funding and access to capital markets. Such goals might include:

- Desired contractual interbank performance agreement (CIPA) scores or targets;
- Net collateral ratio [FCB minimum of 103 percent as prescribed by FCA Regulation 12 CFR 615.5335(a)];
- Interest rate risk sensitivity limits;
- The size and composition of the investment portfolio; and
- Types and limits on various funding alternatives or debt instruments.

Further, an assessment should be completed regarding the adequacy of board direction and control regarding funding. Accordingly, examiners should evaluate the existence and adequacy of board policies or other management direction regarding the institution's overall funding strategy, debt management or liability structure, permissible borrowings, and other relevant issues impacting funding.

An institution's asset/liability management policy is typically where debt management areas are addressed. The policy should require management to periodically (at least quarterly) develop a funding strategy. The policy should describe the process that the board wants followed when the strategy is developed, establish responsibility for funds management decisions, establish board reporting requirements, set objectives, and include a process for approving exceptions.

Senior Management: Senior management manages day-to-day operations to achieve the board's overall objectives. Senior management should develop and implement a debt management plan that:

- Adheres to strategies and policies approved by the board;
- Includes processes that identify, measure, monitor, and control risks incurred by their institution;
- Maintains an organizational structure that clearly assigns responsibility, authority, and reporting relationships;
- Ensures delegated responsibilities are effectively carried out;
- Establishes and maintains an effective internal control environment; and
- Monitors the adequacy and effectiveness of the institution.

The oversight of funding decisions will typically be the responsibility of an institution's Asset/Liability Management Committee (ALCO). This committee should require that debt managers develop quarterly funding strategies that define projected funding configurations. The ALCO should consider providing debt managers with guidelines on what types of debt can and should be issued during coming periods and provide guidance on the amounts and maturities of debt they think would be appropriate. The ALCO should receive reports on all debt retired and issued since its last meeting and how these actions were consistent with approved strategies.

After assessing strategic planning and policy direction, examiners should evaluate the existence and adequacy of management procedures. Procedures should adequately describe the institution's cash flow management process to determine sources and uses of funds over the planning horizon. This analysis should lead bank staff in determining the amount and type of funding needed. Management procedures should outline the process to analyze:

- Available funding alternatives (e.g., term of debt instrument and type of instrument such as: fixed vs. floating; callable vs. noncallable; synthetic funding using derivative instruments; etc.);
- The need to restructure the balance sheet (e.g., defeasance, in-substance defeasance, off-balance sheet restructuring, or internal System debt transfer);
- The costs and benefits of the various alternatives (e.g., net present value, benefit/cost ratio, etc.); and
- Components of interest rate risk associated with each funding alternative (e.g., basis/spread, maturity/repricing, yield curve, option, etc.).

Additional cost/benefit analyses and controls are necessary for those institutions issuing non-dollar denominated or foreign currency denominated debt . This is discussed later in this section.

Predicting future funding needs entails some inherent level of uncertainty. In the event of unexpected loan demand or other unforeseen cash needs, management may need to access other alternative funding sources. Sound contingency planning may include one or a combination of the following:

- Liquidating a portion of the investment portfolio to generate cash;
- Purchasing Federal Funds (i.e., Fed Funds Purchased); or
- Accessing previously established bank lines of credit.

Examiners are cautioned that frequent and sizable use of such funding alternatives may result in higher debt costs and may be indicative of inadequate cash-flow planning.

Effective channels of communicating appropriate controls are required to ensure that all staff fully understand and adhere to policies and procedures affecting their day-to-day responsibilities. Institution communications must ensure that relevant information is reaching all appropriate personnel. It is important that management delegate funding activities to qualified staff with the necessary experience and technical capabilities. Management's internal controls should ensure staff do not ignore or override internal control mechanisms or take inappropriate risk positions. As discussed below, the ability to accurately measure, monitor and control interest rate risk is dependent on reliable management information systems. The effectiveness of such systems is predicated on accurate information, which must be periodically validated.

Internal Controls Systems: Management's system of internal controls is a critical component of safe and sound lending operations. An effective internal control system requires that material risks facing the institution's goals be recognized and continually assessed. Such a system can also help to ensure that the organization complies with all applicable laws and regulations, as well as policies, procedures, strategic plans, and other internal rules. Effective controls should help decrease the risk of unexpected losses or damage to the institution's reputation.

From a debt management perspective, controls must ensure appropriate coordination between risk, investment, and debt managers. Authorization for issuing or incurring debt should be clearly defined by institution procedures and delegations of authority. Controls should also ensure appropriate segregation of duties. There should be periodic reviews of the responsibilities and functions of key individuals to ensure that they are not in a position to conceal inappropriate actions. Sound management controls also include reporting to management, the ALCO, and the board regarding:

- Compliance with prescribed funding limits;
- Compliance with approved funding strategy; and
- Cost of funding.

Further, controls must provide for periodic reconciliation and independent testing of funding data to ensure the reliability and integrity of various reports.

Management Information Systems: Management Information Systems (MIS) should supply internal and external parties with comprehensive financial, operations, and compliance data. Such systems should also provide management with the capability to identify and manage risks facing the institution. An adequate MIS should help determine the cause of these risks, project the potential impact that risks could cause to future operations, and help management explore future actions that could be taken to deal with risk exposures. Also, the MIS should provide management with relevant external market information for future decision making. Such information must be reliable, timely, accessible, and provided in a useable format.

A critical component of an institution's activities is the establishment and maintenance of an MIS that integrates the full range of its activities. From a debt management perspective, the MIS should capture the complete characteristics of all outstanding debt issuances. Analytical capabilities should allow staff to determine what risks currently exist in these operations. This would include the analysis of market risks, credit risks, liquidity risks, and operational risks. Analysis systems should allow staff to project risks into the future under a variety of differing operational scenarios. The MIS should also allow staff to monitor and project anticipated cash flows and calculate the anticipated value of exercising call features imbedded in outstanding debt issuances.

An institution must ensure the accuracy of its simulation, analysis, monitoring, and reporting systems. This can be done through a combination of back-testing, periodic alternative model validations, and auditing. Internal controls have to be sufficient to ensure that data supplied by systems is accurate, timely, and sufficient to meet the needs of the institution. Also, computer simulation models are highly dependent on the basic assumptions used. Accordingly, assumptions should be periodically evaluated to ensure continued applicability. Multiple confirmation and analysis methodologies should be explored to ensure that management is not overly dependent on the internal workings of a given system (or black-box) for monitoring and analysis purposes.

Global Debt Program (GDP) and the Foreign Currency Denominated Debt (FCDD): From a regulatory perspective, the GDP has risks similar to those institutions face in any type of debt decision. The risks associated with dollar-denominated global debt are identical to the domestic issuances. Therefore, examination concerns and Agency expectations are similar to those for domestic issuances, with special attention given to the cost-effectiveness of the program.

FCDD has some very large risks that need to be carefully considered and analyzed before institutions should consider issuance. FCA Bookletter BL-036 clarifies FCA's expectation that banks selling FCDD provide a comprehensive evaluation to their board, senior management, risk management, legal, and accounting personnel, allowing them to fully understand the risks and benefits of issuing such debt. System institutions are directed to manage currency risk through cross-currency swaps. This approach should effectively transfer currency risk to a swap counterparty. Therefore, the major risk to System institutions is counterparty credit risk associated with the swaps. The sophistication of counterparty risk management systems should be commensurate with the volume and complexity of transactions. Any given approach to managing counterparty risk may not be applicable to all institutions.

Examiners should determine whether:

- The foreign currency risk is hedged (final net/net to the institution is U.S. dollars to U.S. dollars).
- Expectations of FCA Bookletter BL-023, *Guidelines for Utilizing Derivative Products,* are being met.
- Counterparty risk exposures are understood and have been properly analyzed by senior management and the board of directors.
- The cost advantages (versus domestic offerings) of the transaction warrant the increased risk exposures.
- The MIS allows for tracking of transactions.
- Controls, monitoring, and reporting systems are adequate.
- Transactions are in accordance with board-approved policies and bank procedures.
- Operational and legal risks are understood and managed.

EXAMINATION PROCEDURES

Examination procedures for funding and debt management are detailed in FCA Workpaper 4350. These procedures provide guidance for evaluating the adequacy of management's planning, policies, procedures, and controls as they relate to debt management operations. Although they primarily apply to FCBs; some direct lender associations or other related System entities may have sufficient discretionary control over funding decisions to justify a more thorough examination of debt management (e.g., the completion of examination procedures 34 and 35). Consistent with risk-based examination principles, examiners should add, delete, or modify procedures as needed based on the particular circumstances of the institution.