

Farm Credit Administration

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INFORMATIONAL MEMORANDUM



October 21, 2003

To: Chairman, Board of Directors
Chief Executive Officer
All Farm Credit Institutions

From: Roland E. Smith, Director
Office of Examination

Subject: Counterparty Risk

Farm Credit System (FCS or System) institutions are more frequently engaging in financial transactions with System and non-System counterparties. If structured properly, doing business with counterparties is a sound business practice that can help manage and diversify risks, improve earnings and capital, and better serve the market place. However, over-reliance on a single counterparty is risky and could adversely impact the safety and soundness of an institution. This memorandum informs FCS banks and associations as to what the Farm Credit Administration (FCA) will evaluate when it examines counterparty risk. It also emphasizes areas for consideration by bank and associations in managing counterparty risk.

Counterparty risk derives from the exposure to a single party in a financial transaction. (1) It is the risk in a transaction that may occur if the counterparty is unable to perform in accordance with the agreements executed with your institution. Excessive exposure to counterparty risk has the potential to cause significant financial loss to a System institution and its shareholders.

It is important that each System bank and association be able to accurately measure and effectively manage exposure to counterparties. It is equally important for the board of each bank and association to establish a policy with appropriate limits to ensure that counterparty risks are consistent with the institution's risk-bearing capacity. In addition, we believe the System should assess its combined exposure to single counterparties. FCS institutions should consider jointly developing policies and practices that limit exposure to single counterparties within a district and throughout the System. The FCS should also consider alternative strategies that address situations where cumulative exposures to single counterparties are, or could become, excessive.

(1) Exposure to counterparty risk in financial transactions is similar to exposure to loss from a single credit risk in loans. FCA's lending limit regulations in 12 C.F.R. Part 614, subpart J restrict lending to a single credit risk to 25 percent of an institution's lending base.

Investments and financial derivatives (such as interest rate swaps) expose FCS institutions to counterparty risks. Another source of counterparty risk is credit enhancements, such as standby commitments, guarantees, and recourse on loans. FCA Regulation § 615.5133 addresses counterparty risk in investments, while Bookletter No. 023 covers counterparty risk in financial derivatives, and Bookletter No. 036 addresses counterparty risk in the global debt program.

In accordance with sound business practices, it is incumbent on each board of directors to establish internal controls that limit counterparty risk in order to preserve the institution's financial strength under adverse conditions. As such, each institution board should carefully consider the amount of its capital that could be exposed to another institution in a financial transaction without the institution's safety and soundness becoming too dependent on the financial performance of another single institution. A best practice is for these limits to be expressed as a percent of permanent capital or total net worth. In addition, it is important that you carefully consider the impact on the institution's earnings stream if a counterparty is unable to perform.

It is an essential risk management practice to carefully consider the financial condition of potential counterparties. The institution's policy should establish controls that limit transactions to counterparties based on their financial condition. The board should consider whether the bank or association will engage in transactions only with counterparties that have been assigned one of the highest two credit ratings by a nationally recognized statistical rating organization, commonly referred to as an NRSRO. However, such ratings do not absolve the board and management from their responsibility to (1) exercise due care in dealings with counterparties, and (2) perform due diligence in selecting counterparties and establishing limits on your institution's transactions with them. If an institution already has exposure beyond its capital level or limits established in its policy, this could be considered an unsafe and unsound practice and that exposure should be reduced.

Board Policy

In reviewing your policy on counterparty exposure, examiners will consider whether the policy prescribes:

- Criteria for appropriate due diligent analysis including processes for measuring and managing counterparty risk;
- Criteria for selecting and maintaining relationships with counterparties, which may include credit ratings;
- Controls that limit the exposure of capital to single counterparties expressed as a percent of the institution's capital base;
- Periodic reporting and monitoring of counterparty exposures to the board;
- Periodic reporting to the board on each counterparty's financial condition, including an assessment of its ability to perform on agreements and contracts executed with your institution; and
- Actions to mitigate your exposure in the event the financial condition of a counterparty deteriorates and doubts arise about its ability to perform in accordance with the agreements and contracts you have executed.

If you have any questions about this memorandum, please contact me at 703-883-4160 or at my e-mail address smithr@fca.gov.