Farm Credit Administration

1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000

INFORMATIONAL MEMORANDUM

May 2, 2012

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

From: Gary K. Van Meter, Director
Office of Regulatory Policy

Gary K. Van Meter

Subject: Long-Term Standby Purchase Commitments

Purpose/Summary

This Informational Memorandum (IM) describes the treatment of Farm Credit System (System) loans covered by the Federal Agricultural Mortgage Corporation's (Farmer Mac) Long-Term Standby Purchase Commitment (Commitment) program for purposes of:

- Lending limits calculations under 12 CFR Part 614, Subpart J;
- Risk weighting of loans for regulatory capital ratios under 12 CFR Part 615, Subparts H and K; and
- Regulatory reporting and disclosure of asset quality statistics and System risk ratings.

The conclusions we make are specifically based on our understanding of the Commitment program (Program) as of the date of this IM. Any changes to the Program could result in different conclusions.

Background

Farmer Mac has been providing Commitments on loans held by System institutions since 1999. The Program is one of numerous concentration risk mitigation arrangements available to System institutions. Commitments are established through agreements entered into between Farmer Mac and a System bank or association (institution). Under a Commitment agreement, the System institution places certain loans into a designated pool. The loans must meet Farmer Mac's credit underwriting, collateral valuation, documentation and loan servicing requirements. Eligible loan collateral includes agricultural real estate that is a parcel or parcels of land, or buildings and structures affixed to the land, used for the production of one or more agricultural commodities or products. Agricultural real estate can also include certain primary residences located in rural areas.

Under the typical Commitment agreement, Farmer Mac agrees to a future purchase of one or more loans from the designated pool when certain criteria are met. Farmer Mac assumes, for a fee, the credit risk on the pool of loans. The System institution retains all loans in the loan pool in its portfolio until delivery of each such loan to Farmer Mac for purchase, which is normally when a loan becomes 90 or 120 days delinquent in its payments. On rare occasions, Farmer Mac has modified the standard Commitment structure to reduce the fee paid by a System institution. In such cases, the Commitment agreement requires the System institution to retain the credit risk on a certain percentage of the first losses on the pool of loans covered by the Commitment. Farmer Mac requires Commitment counterparties to make representations and warranties regarding conformity of loans to its underwriting standards. Farmer Mac may decline to purchase defaulted loans out of Commitment pools upon a material breach of these representations and warranties.

Questions and Answers

A. <u>Lending Limits</u>

1. **Is a Commitment agreement treated as a guarantee agreement "entered into by or among System banks and associations" under § 614.4345 of FCA's lending and leasing limits regulations?**

   Yes. Notwithstanding that Commitment agreements are not described as guarantees, they serve the same function and purpose as a guarantee. Therefore, a Commitment is treated as a qualifying guarantee under § 614.4345 for the purpose of computing the loans to a single borrower under § 614.4358(b)(2).

2. **Are the covered portions of loans in a Commitment pool excluded from the System institution's lending limit calculations under § 614.4358?**

   Yes. Since a Farmer Mac Commitment qualifies as a guarantee under § 614.4345, loans in the Program may be omitted from the System institution's lending limit calculation under § 614.4358(b)(2), but only up to the amount of the portion of such loans covered by the Commitment less borrower stock.

3. **What is the effect on a System institution's lending limit calculations under § 614.4358 when there is a material breach of the representations and warranties with respect to a loan in a Commitment pool?**

   When a material breach of the representations and warranties occurs with respect to a loan in a Commitment pool, the Commitment on that loan is no longer valid. As such, the portions of loans previously covered by a Commitment agreement must be ***included*** in the

System institution's lending limit calculation under § 614.4358(a). The Commitment on all other loans in the Commitment pool continues to be valid so such remaining loans in the Commitment pool may continue to be omitted from the System institution's lending limit calculation under § 614.4358(b)(2), but only up to the amount of the portion of such loans covered by the Commitment less borrower stock.

4. **Does the FCA consider use of the Program a valid component of a System institution's concentration risk mitigation policy?**

Yes. It is essential that each System institution, based on the unique risks in its territory and risk-bearing capacity, identify, define and effectively mitigate concentration risks. Therefore, the use of Commitments may be considered by each System institution as part of its overall concentration risk mitigation policy.[1] Concentration risks resulting, for example, from lending to producers/borrowers in territories that have limited agricultural markets or few agricultural sectors may be mitigated, but not eliminated, through guarantees such as those provided by the Program or by other loss-sharing agreements.[2] Accordingly, System institutions are still responsible for underwriting loans on a sound and constructive basis and ensuring that they adhere to Farmer Mac servicing and other requirements. As such, System institutions should not underwrite an unsafe or unsound loan on the basis of a Commitment providing risk mitigation.

B. <u>Risk Weighting of Loans for Regulatory Capital Ratios</u>

1. **What is the correct asset risk category under § 615.5211 for loans covered by a Commitment?**

The loans and portions of loans covered by a Farmer Mac Commitment agreement are assigned to the 20-percent risk category under § 615.5211(b)(6) because they are "claims on, and portions of claims guaranteed by, [a] Government-sponsored agenc[y] . . . ."[3] As noted above, the Commitments serve the same function and purpose as a guarantee.

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[1] Effective July 1, 2012, "the board of directors of each title I, II, and III System institution must adopt and ensure implementation of a written policy to effectively measure, limit and monitor exposures to concentration risks resulting from the institution's lending and leasing activities." 76 FR 29992 (12 CFR § 614.4362).

[2] Beginning July 1, 2012, a System institution's concentration risk mitigation policy must address counterparty risk, which would include when using guarantees provided by the Program or by other loss-sharing agreements. *Id*. *See also* IM dated October 21, 2003, regarding counterparty risk.

[3] Under § 615.5210(f), the FCA reserves its authority, on a case-by-case basis, to determine the appropriate risk weight for any guaranteed loan portion, or a security that is backed by a guaranteed loan portion, that imposes risks that are not commensurate with a 20-percent risk weighting. Additionally, future amendments to the FCA's capital regulations may affect risk weightings.

2. **Does the portion of credit risk retained on the first losses for loans covered by a Commitment meet the definition of "residual interest" as defined in § 615.5201?**

   Yes. The portion of credit risk retained on the first losses for loans covered by a Commitment is not unlike the credit risk retained on a securitization, whereby the risk of credit losses from the underlying assets is distributed to different parties. The "first dollar," or most subordinate, loss position is first to absorb credit losses; the most "senior" position is last to absorb losses. Each loss position functions as a credit enhancement for the more senior positions in the structure.

   A "residual interest" includes any on-balance sheet asset that "exposes an institution to credit risk directly or indirectly associated with the transferred asset that exceeds a pro rata share of that institution's claim on the asset, whether through subordination provisions or other credit enhancement techniques."[4] Also, residual interests may include credit-enhancing retained subordinated interests.[5] As such, the portion of credit risk retained on the first losses for loans covered by a Commitment, which functions as a credit-enhancement, is a residual interest as defined in § 615.5201.

3. **What is the appropriate treatment of the portion of credit risk retained on the first losses (residual interests), if any, for a pool of loans covered by a Commitment?**

   Residual interests for loans covered by a Commitment receive the same treatment as residual interests for a loan or portion of a loan that is not in a pool of loans covered by a Commitment. To our knowledge, no residual interests retained by System institutions under the Program have been externally rated. Consequently, the face amounts of such residual interests are risk weighted under § 615.5210(c), which requires a dollar-for-dollar deduction from capital and assets (dollar-for-dollar deduction).[6]

   We impose the dollar-for-dollar treatment for these residual interests because the level of credit risk exposure associated with deeply subordinated assets, particularly subinvestment grade and unrated residual interests, is extremely high. Residual interests are generally subordinated to all other positions.

<u>C. Asset Quality Statistics and System Risk Ratings</u>

1. **How are loans in the Program treated for purposes of regulatory reporting and disclosures related to asset quality statistics?**

   Generally, loans in the Program would be classified as Acceptable, even if repayment problems or other credit weaknesses exist, provided the System institution has not done anything to undermine or jeopardize either the validity or enforceability of the

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[4] 70 FR 35336 (June 17, 2005).
[5] *Id*.
[6] *See supra* note 3.

Commitment. This treatment also is consistent with §§ 621.6(c) since loans being serviced in accordance with the terms of the Program are normally presumed to be in process of collection and adequately secured. Nevertheless, if a loan in the Program becomes 90 days past due, it must be disclosed in the performance category "Loans 90 days past due still accruing interest" under § 621.6(c). However, if it becomes evident there is risk of loss and the loan is no longer fully collectible despite the existence of the Commitment, the loan must be transferred to nonaccrual as prescribed by § 621.6(a).[7]

Furthermore, if the collectability or enforceability of the Commitment is in doubt because the System institution's compliance with the terms of such Commitment is questionable, the loan should be classified, accounted for, and reported in a manner consistent with its own unique risks without reliance upon the Commitment for ultimate collection.

2. How should loans in the Program be rated for risk management purposes?

Under the terms of the Program, the Commitment limits a System institution's losses in the event of default, but it does not affect the likelihood of default. Thus, when a loan is placed in the Program its probability-of-default would be unaffected, but its loss-given-default would be reduced. The Combined System Risk Rating Guidance developed by the System contains related risk rating guidance.

Contacts

If you have any questions about this memorandum, please contact Paul Gibbs, Senior Accountant, Office of Regulatory Policy, at (703) 883-4203 (gibbsp@fca.gov), or Gary Van Meter, Director, Office of Regulatory Policy, at (703) 883-4026 (vanmeterg@fca.gov).

[7] *See also* IM dated July 10, 1998, for further discussion of the treatment of loans guaranteed by federal and local government agencies.