Farm Credit Administration

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INFORMATIONAL MEMORANDUM

March 22, 2011

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

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

Gary K. Van Meter

Subject: USDA Guaranteed Investments

Introduction and Background

The purpose of this Informational Memorandum (IM) is to reiterate and clarify that Farm Credit System (System) institutions have broad authority to invest in obligations (including loans and bonds) that are **fully insured or guaranteed** by the United States Department of Agriculture (USDA) and its agencies. System institutions may purchase unconditionally guaranteed portions of loans/bonds in the secondary market using their existing investment authority.[1] This investment activity supports the secondary market and helps to improve the flow of funds to rural areas.

The Farm Credit Administration (FCA) is committed to helping ensure a dependable source of credit for agriculture and rural America so farmers, ranchers, and their rural communities can flourish. System institutions can use their existing investment authority to help meet the financing needs of agriculture and rural America in the 21st century. These guaranteed investments can help increase the availability of long-term credit to farmers, ranchers, agribusiness, and other rural residents at stable interest rates. They can also help improve the liquidity of agricultural lenders, provide new capital for agricultural investments, and enhance the ability of individuals in rural communities to obtain financing for farmland and moderately priced homes. Further, such investments can also provide System institutions an additional tool to diversify the credit risk exposures in their agricultural loan portfolios.

Investment Authority

Under FCA regulation § 615.5140(a)(1), System institutions have broad authority to invest in obligations (including loans) that are "fully insured or guaranteed by the United States, its agencies, instrumentalities, or corporations." This authority applies only to obligations that are unconditionally guaranteed as to both principal and interest by such entities.[2] Farm Credit System banks may hold these investments in an amount not to exceed 35 percent of outstanding loans, to comply with liquidity reserve requirements, to manage surplus short term

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[1] This authority does not extend to obligations where *only* the underlying collateral is fully insured or guaranteed by the USDA.
[2] *See* 56 FR 65691, December 18, 1991.

funds, and to manage interest rate risk.[3] An association may hold these investments with the approval of its funding bank.[4] System institutions may use this authority to support their mission objectives by investing in guaranteed agricultural, rural housing, rural utility, or rural economic development loans and other obligations made in accordance with the framework laid out in FCA Bookletter BL-064, *Farm Credit System Investment Asset Management* (December 9, 2010), under various programs of the USDA, which is an agency of the United States.

The USDA has several rural development programs, which provide guarantees, including (1) the Farm Service Agency (FSA), which provides credit for farm ownership and operating loans; (2) the Rural Utilities Service, which addresses rural America's need for basic services, such as clean water, sewers and waste disposal, electricity and telecommunications; (3) the USDA Rural Development, which addresses rural America's need for water and sewer systems, housing, health clinics, emergency service facilities and electric and telephone service; and (4) the Rural Business and Cooperative Service, which provides technical assistance and financing for rural businesses and cooperatives to create quality jobs in rural areas.

While the USDA guarantee significantly reduces the risk for all participants and provides a useful and effective risk management tool, not all USDA guarantees are unconditional. Servicing responsibilities of an originator (generally, the Lender of Record or bond servicing agent) make the USDA guarantee conditional. The "Lender of Record" as defined by the USDA is the person or organization making and servicing the loan or bond which is guaranteed under the provisions of the applicable subpart of 7 C.F.R. 1980. The Lender of Record is also the party requesting the guarantee. The guarantee is conditional because the Lender of Record requesting it must satisfactorily perform certain servicing requirements for the guarantee to remain effective. Negligent servicing is defined as the failure to perform those services which a reasonably prudent lender would perform in servicing its own portfolio of loans that are not guaranteed.

In contrast, System institutions that invest in portions of loans/bonds guaranteed by the USDA, have no servicing responsibilities and hold and maintain an appropriately documented assignment of guarantee (Holders) have an **unconditional** full faith and credit guarantee by the USDA that can be sold in the secondary market. The "Holder" as defined by the USDA is the person or organization other than the Lender of Record who holds all or part of the guaranteed loan or bond with no servicing responsibilities. When the Lender of Record assigns a part of the loan or bond to an assignee, the assignee becomes a Holder only when Form RD 449-36, "Assignment Guarantee Agreement," is used. The full faith and credit obligation of the USDA is incontestable except for fraud and misrepresentation of which the Lender of Record or any Holder has actual knowledge, or which a Lender of Record or any Holder participates in or condones.

In addition to the general authority to invest in obligations fully insured by the United States or its agencies, instrumentalities or corporations, System institutions may hold other investments as approved by the FCA. Section 615.5140(e) states that "[y]ou may purchase and hold other investments that we approve. Your request for our approval must explain the risk characteristics of the investment and your purpose and objectives for making the investment." System institutions have used this authority to request FCA approval of new investments that fund the needs of agriculture or rural America under certain conditions. For example, System institutions may invest in obligations that are guaranteed under USDA programs, including

[3] 12 C.F.R. 615.5132.
[4] 12 C.F.R. 615.5142.

investments made under pilot programs approved by the FCA such as the Rural America Bond (RAB), Agricultural and Rural Community (ARC) bond and other similar programs.[5] Importantly, System institutions that are not participating in these pilot investment programs still may purchase and hold USDA guaranteed obligations as discussed in this IM.

Investment Management

Sections 2.2(10) and 2.12(18) of the Farm Credit Act of 1971, as amended, require each System bank to approve the investment activities of its affiliated associations. Likewise, § 615.5142 authorizes associations to hold eligible investments with the approval of their funding bank. Nonetheless, this oversight requirement for System banks does not release an association's board and managers of their duty to manage investments in a safe and sound manner.

System banks and associations also must establish investment management policies and practices that are appropriate for the nature and risk characteristics of their investment activities in accordance with § 615.5133. While the risk is considered to be well mitigated on those transactions where a System institution purchases the portion of a loan or bond that is fully guaranteed by the USDA, appropriate due diligence and analysis is still required for these transactions. FCA Bookletter BL-064 provides clarification and guidance regarding the FCA's regulations and lays out the FCA's expectations with respect to the key elements of a robust investment asset management framework that each System institution should establish to prudently manage its investments in changing markets.

Risk-Weighting

In order for System institutions to arrive at a "risk-adjusted asset" amount, § 615.5211 assigns balance sheet assets to various risk categories (e.g., zero, 20, 50, 100 or 200 percent). That risk-adjusted asset amount is then used to calculate various capital adequacy ratios.

As provided by § 615.5211(a)(3), System institution assets that represent "direct claims on, and portions of claims *unconditionally guaranteed* by the U.S. Treasury, government agencies, or central governments in other OECD countries," are assigned to the zero percent risk category. System institutions that purchase instruments guaranteed by the USDA in the secondary market may assign those assets to the zero percent risk category as long as the guarantee is "unconditional." For purposes of § 615.5211(a)(3), the USDA guarantee is unconditional if both the applicable regulations governing the loan guarantee program and the applicable loan, assignment, and secondary market documents provide the following:

- The guarantee is an obligation supported by the full faith and credit of the United States.
- The loan or bond is secured by an assignment of the guarantee on appropriate forms from the USDA (Form numbers may vary by program).
- The System institution has possession/control over the assignment.

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[5] The RAB bond pilot program enables System institutions in the AgFirst Farm Credit Bank and Farm Credit Bank of Texas districts to better meet the changing financing needs of agricultural enterprises, agribusinesses, and rural communities by creating an additional source of dependable, affordable, and flexible financing through investments and partnerships. The ARC bond pilot program authorizes associations in the AgriBank, FCB, district to invest in bonds that provide goods and services to farmers, ranchers, agribusinesses, and their rural communities, residents, and businesses. U.S. AgBank, FCB, and CoBank, ACB, have each established similar pilot programs.

- The guarantee is incontestable except for fraud or misrepresentation that the holder participates in, condones, or of which it has knowledge.
- The validity of the guarantee is not dependent on any affirmative action (such as servicing or reporting) by the purchaser of the guaranteed portion of the loan in the secondary market.

The USDA programs are examples of programs that provide unconditional guarantees to *secondary* market investors or Holders and thus are suitable for zero-percent risk weighting. 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 zero-percent risk weighting. Additionally, future amendments to the FCA's capital regulations may affect risk weightings.

If the USDA guarantee does not satisfy the above factors, it is considered to be a conditional guarantee. For example, the Lender of Record's responsibility to satisfactorily perform certain servicing requirements makes the USDA guarantee conditional, so it would not be eligible for the zero percent risk category. Under § 615.5211(b)(5), portions of loans and other claims that are conditionally guaranteed by government agencies are assigned to the 20-percent risk category. In addition, if a System institution purchases a participation interest in the entire loan or bond and the USDA guarantee has not been assigned to such System institution, such participations also are assigned to the 20-percent risk category.[6]

The characteristics of the USDA programs may change in the future. Therefore, it is necessary for System institutions investing in USDA assignments, and guaranteed loan portions under USDA programs to ensure that the above factors are satisfied for a particular asset before assigning a loan or bond to a risk category.

Reporting Requirements

Call Report

Part 621, Subpart D, of FCA's regulations establishes requirements for reports of financial condition and performance (Call Reports) filed with the FCA by System institutions, and require that the Call Reports be prepared in accordance with instructions and specifications prescribed by the FCA. System institutions (Holders) should report their USDA guaranteed obligations purchased in the secondary market or at closing as investments in the Call Report, whereas loans that System institutions originate under USDA programs should be reported as loans.

Mission Related Investment (MRI) Report

System institutions (Holders) also should report their USDA guaranteed obligations purchased in the secondary market or at closing as investments on the MRI Report. The MRI Report serves as a memoranda of the Call Report to identify the amounts of mission related investments for the purposes delineated in IMs dated June 25, 2004, and January 11, 2005, and authorized under § 615.5140(a), 615.5140(e), 615.5172, 615.5174 or FCA Bookletter BL-52.

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[6] 12 C.F.R. 615.5211(b)(5).

The MRI Report contains detailed instructions for reporting various types of securities, whether they are held to maturity or available for sale, and whether they are unconditionally guaranteed by the United States. MRI securities, which include both conditional and unconditional obligations by the USDA, should be listed under the appropriate category of lines 1(a) through 1(h) of the MRI Report. MRI securities that are *unconditionally* guaranteed by the USDA also should be reported on line 1(n).

In addition, investments made under pilot programs approved by the FCA, such as the RAB and ARC bond pilot programs should be individually listed on the Pilot Program Investment report, which is part of the MRI Report.

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, Acting Director, Office of Regulatory Policy, at (703) 883-4026 (vanmeterg@fca.gov).