Farm Credit Administration

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

INFORMATIONAL MEMORANDUM

December 23, 2002

To: Chairman, Board of Directors
Chief Executive Officer
All Farm Credit Banks and Associations

From: Michael M. Reyna
Chairman and Chief Executive Officer

Subject: Possible Effects of the Farm Security and Rural Investment Act on Farm Credit System Institution Authorities

BACKGROUND

Enactment of the Farm Security and Rural Investment Act (Pub. L. No. 107-171) (FSRIA) amended the Farm Credit Act of 1971, 12 U.S.C. §§ 2001 et seq. (Act), and the Consolidated Farm and Rural Development Act, 7 U.S.C. §§ 1921 et seq. (RDA). The amendments to the Act affect Farm Credit System (FCS) institutions and Farm Credit Administration (FCA) regulations with respect to: (1) "similar entity" participations and (2) financing under Title III of the Act. In addition, amendments to the RDA permit FCS institutions to establish or invest in rural business investment companies (RBICs). This informational memorandum provides a brief explanation and some preliminary guidance concerning these changes.

"SIMILAR ENTITY" PARTICIPATIONS

The FSRIA amended sections 3.1(11)(B) and 4.18A of the Act so that one type of FCS institution no longer needs approval from another type of FCS institution when it participates with a non-FCS lender in certain loans to a "similar entity."[1] These amendments to the Act have eliminated the statutory basis for some approvals required by existing FCA regulations. See 12 C.F.R. § 613.3300 (d). While these amendments to the Act do not grant new lending authorities or affect other limitations on "similar entity" participations, we plan to make technical changes to conform Part 613 of FCA regulations to the amended statutory language.

TITLE III FINANCING

The FSRIA also amended section 3.7(b)(1) of the Act, the provision that formerly permitted a bank operating under Title III of the Act (CoBank, ACB) to finance certain international transactions involving "farm supplies." After the amendment of section 3.7(b)(1), CoBank, ACB, can finance certain international transactions involving "agricultural supplies," which is statutorily defined to include farm supplies, agriculture-related processing equipment, agriculture-related machinery, and other capital goods related to the storage or handling of agricultural commodities or products. Because of this amendment, the definition of "farm supplies" in FCA regulation § 613.3200 (a) no longer defines the limit of this authority. We are considering future rulemakings in which we may amend our definition of "agricultural supplies" and make conforming changes to Part 613.

RURAL BUSINESS INVESTMENT PROGRAMS

The FSRIA amended the RDA by adding a subtitle H, establishing a "Rural Business Investment Program." The new subtitle permits FCS institutions to establish or invest in RBICs, but limits an individual FCS institution's investment in RBICs. The statute also limits the activities of a RBIC in which one or more FCS institutions or their affiliates own more than 15 percent of the shares.

While the Secretary of Agriculture is responsible for promulgating regulations governing RBICs, the FCA continues to be responsible for addressing any issues pertaining to your institution's investments in RBICs, including safety and soundness issues. The legislative history of the FSRIA indicates that Congress intended that "financial institution regulators including the Farm Credit Administration . . . continue to have the authority to impose on any financial institution that they regulate any safeguard, limitation, or condition that the regulator considers to be appropriate (including, without limitation, any investment limit that is lower than the investment limit that this section imposes on insured depository institutions)."

Equity investments in entities such as RBICs may pose additional risks to your institution. Therefore, sound investment and risk management practices are crucial to successful equity investment activities, including:

- Active involvement and oversight by the board of directors and senior management;
- Appropriate policies, limits, procedures, and management information systems; and
- Appropriate internal controls which consider the high-risk nature of equity investments.

Before making equity investments, each FCS institution's board should review and update its investment policies in accordance with FCA regulations. See, e.g., 12 C.F.R. § 615.5133. Specifically, investment policies should be consistent with your institution's financial condition, risk profile, and risk tolerance. The board should actively monitor the performance and risks of equity investments in light of established objectives, strategies, and policies. Institutions engaging in equity investment activities should have a sound process for executing all elements of investment management processes, including initial due diligence, periodic reviews, investment valuation, and measurement of returns. Policies should clearly establish the exposure limits that the institution is willing to accept, expected holding periods, and criteria for liquidation or divestiture of under-performing equity investments.

Valuations of equity investments often require a significant degree of analytical expertise and judgment and may have an impact on the earnings and capital of your institution. Therefore, clearly articulated policies and procedures on the accounting and valuation methodologies used for equity investments should be established. Additionally, FCS institutions engaged in these activities should assess their methods of allocating capital based on inherent risks, which may exceed regulatory capital minimums established for more traditional activities. Given the importance of shareholder disclosure, institutions should ensure they disclose sufficient information for shareholders to appropriately assess the risk profile and performance of the institution's investment activities.

We intend to collaborate with the United States Department of Agriculture as it develops rules to license RBICs. In addition, we anticipate that the Investments in Rural America proposed rule, which is included in our recent Unified Agenda, will address RBICs, discussing safe and sound equity investment practices. If you have any questions regarding the effects of the FSRIA on FCS institution authorities, please contact Laurie Rea, Senior Policy Analyst (ReaL@fca.gov) or Dale Aultman, Policy Analyst (AultmanD@fca.gov), at (703) 883-4498, TTY (703) 883-4434. You may also contact James Morris, Senior Counsel (MorrisJ@fca.gov), at (703) 883-4020, TTY (703) 883-2020.

[1] "Similar entity" means a party that is ineligible for a loan from a Farm Credit bank or association, but has operations that are functionally similar to the activities of eligible borrowers in that a majority of its income is derived from, or a majority of its assets are invested in, the conduct of activities that are performed by eligible borrowers.