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[6705-01-P]

FARM CREDIT ADMINISTRATION

Market Access Agreement

AGENCY: Farm Credit Administration.

ACTION: Notice of Draft Second Amended and Restated Market Access Agreement; request for comments.

SUMMARY: The Farm Credit Administration (FCA or we) is publishing for comment the Draft Second Amended and Restated Market Access Agreement (Draft Second Restated MAA) proposed to be entered into by all of the banks of the Farm Credit System (System or FCS) and the Federal Farm Credit Banks Funding Corporation (Funding Corporation). This Draft Second Restated MAA is an update to and would replace the Amended and Restated MAA (Amended and Restated MAA) approved by the FCA on January 9, 2003, and published in the Federal Register on January 15, 2003 (68 FR 2037). The Draft Second Restated MAA sets forth the rights and responsibilities of each of the parties when the condition of a bank falls below pre-established financial thresholds.

DATES: You may send comments on or before December 1, 2011.

ADDRESSES: There are several methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (faxes) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.

- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."

- Federal E-Rulemaking Web site: http://www.regulations.gov. Follow the instructions for submitting comments.

- Mail: Send mail to Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters.

Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

System banks and the Funding Corporation entered into the original Market Access Agreement (original MAA) on September 1, 1994, to help control the risk of each System bank by outlining each party's respective rights and responsibilities in the event the condition of a System bank fell below certain financial thresholds. As part of the original MAA, System banks and the Funding Corporation agreed to periodic reviews of the terms of the MAA to consider whether any amendments were appropriate. The original MAA was updated by the parties in 2003 in the Amended and Restated MAA and received FCA approval following notice and request for public comments in the Federal Register.[1]

On December 3, 2010, the FCA Board approved amendments to the Amended and Restated MAA that would conform its provisions to the System banks' proposed Joint and Several Liability Reallocation Agreement (Reallocation Agreement) to ensure that the MAA provisions did not impede operation of the Reallocation Agreement; the amendments also provided that the MAA and the Reallocation Agreement are separate agreements, and invalidation of one does not affect the other. The FCA published these amendments in the Federal Register.[2] The proposed Reallocation Agreement is an agreement among the banks and the Funding Corporation that establishes a procedure for non-defaulting banks to pay maturing System-wide debt on behalf of defaulting banks prior to a statutory joint and several call by the FCA under section 4.4 of the Farm Credit Act of 1971, as amended (Act).[3] The FCA Board approved the proposed Reallocation Agreement on October 14, 2010, and notice of the approval was published in the Federal Register.[4] The System banks have approved the Reallocation Agreement but have not yet executed it.

The Amended and Restated MAA has a termination date of December 31, 2011. The System banks and the Funding Corporation have requested the FCA to approve the Draft Second Restated MAA at this time in order to have it approved by the parties and in place when the current agreement terminates. The FCA seeks public comment on the proposed agreement.

The Amended and Restated MAA establishes certain financial thresholds at which conditions are placed on the activities of a bank or restrictions are placed on a bank's access to participation in System-wide and consolidated obligations. The MAA establishes three categories, which are based on each bank's net collateral ratio, permanent capital ratio, and scores under the Contractual Inter-bank Performance Agreement, which is an agreement among the banks and the Funding Corporation that establishes certain financial performance criteria.

The proposed Second Restated MAA retains the same general framework and most of the provisions of the Restated and Amended MAA, updated as necessary. An important change is to section

1.05, which revises the level of the net collateral ratio that would place a bank in Category I. The revision takes into account that the FCA has increased the minimum net collateral ratio for some banks to an amount higher than the 103 percent stated in FCA regulation 12 CFR 615.5335. Revisions to the sections that refer to the Reallocation Agreement clarify that such agreement has not been executed. In addition, certain voting and quorum procedures in Article II and Article VI of the proposed Second Restated MAA will require consent or approval of all banks rather than a majority of banks; this change recognizes that there are now only five System banks and are likely to be only four System banks as of January 1, 2012.[5]

The Second Restated MAA, together with the recitals to the amendment, is as follows:

SECOND AMENDED AND RESTATED MARKET ACCESS AGREEMENT
AMONG
AgFirst Farm Credit Bank
AgriBank, FCB
CoBank, ACB
Farm Credit Bank of Texas
U.S. AgBank, FCB
And
Federal Farm Credit Banks Funding Corporation

This SECOND AMENDED AND RESTATED MARKET ACCESS AGREEMENT (the "Restated MAA") is entered into among AgFirst Farm Credit Bank, AgriBank, FCB, CoBank, ACB, the Farm Credit Bank of Texas, U.S. AgBank, FCB (collectively, the "Banks") and the Federal Farm Credit Banks Funding Corporation ("Funding Corporation").

WHEREAS, the Banks and the Funding Corporation entered into that certain Market Access Agreement dated September 1, 1994 and effective as of November 23, 1994, (the "Original Agreement") for the reasons stated therein; and

WHEREAS, the Original Agreement was subsequently amended by that certain Amended and Restated Market Access Agreement, dated July 1, 2003, referred to herein as the "First Restated MAA," for the reasons stated therein; and

WHEREAS, pursuant to Sections 7.04 and 7.05 of the First Restated MAA, the Banks and the Funding Corporation have reviewed the First Restated MAA to consider whether an extension and any amendments to it are appropriate; and

WHEREAS, representatives of the Banks and the Funding Corporation met various times in connection with such review and recommended an extension of the First Restated MAA and certain amendments for presentation to the Committee; and

WHEREAS, the Committee met various times in connection with the review and recommended an extension of the First Restated MAA and certain amendments for presentation to the Banks and the Funding Corporation; and

WHEREAS, the boards of directors of the Banks and of the Funding Corporation approved this Restated MAA in principle; and

WHEREAS, thereafter, this Restated MAA was submitted to FCA for approval and to the Insurance Corporation for an expression of support; and

WHEREAS, FCA published this Restated MAA in the Federal Register and sought comments thereon; and

WHEREAS, FCA approved this Restated MAA, subject to approval of this Restated MAA by the boards of directors of the Banks and the Funding Corporation, and a notice of such approval was published in the Federal Register; and

WHEREAS, the Insurance Corporation expressed its support of this Restated MAA; and

WHEREAS, the Parties are mindful of FCA's independent authority under Section 5.17(a)(10) of the Act to ensure the safety and soundness of Banks, FCA's independent authority under Sections 4.2 and 4.9 of the Act to approve the terms of specific issuances of Debt Securities, the Insurance Corporation's independent authority under Section 5.61 of the Act to assist troubled Banks, and the Banks' independent obligations under Section 4.3(c) of the Act to maintain necessary collateral levels for Debt Securities; and

WHEREAS, the Banks are entering into this Restated MAA pursuant to, inter alia, Section 4.2(c) and (d) of the Act; and

WHEREAS, the Funding Corporation is prepared to adopt as the "conditions of participation" that it understands to be required by Section 4.9(b)(2) of the Act each Bank's compliance with the terms and conditions of this Restated MAA; and

WHEREAS, the Funding Corporation believes the execution and implementation of this Restated MAA will materially accomplish the objectives which it has concluded are appropriate for a market access program under Section 4.9(b)(2) of the Act; and

WHEREAS, prior to the adoption of the Original Agreement, the Funding Corporation adopted and maintained in place a Market Access and Risk Alert Program designed to fulfill what it understood to be its responsibilities under Section 4.9(b)(2) of the Act with respect to determining "conditions of participation," which Program was discontinued by the Funding Corporation in accordance with the terms of the Original Agreement; and

WHEREAS, the Funding Corporation is entering into this Restated MAA pursuant to, inter alia, Section 4.9(b)(2) of the Act; and

WHEREAS, the Parties believe that the execution and implementation of this Restated MAA will accomplish the objectives intended to be achieved by the Original Agreement,

NOW THEREFORE, in consideration of the foregoing, the mutual promises and agreements herein contained, and other good and valuable consideration, receipt of which is hereby acknowledged, the Parties, intending to be legally bound hereby, agree as follows:

ARTICLE I - CATEGORIES

Section 1.01. Scorekeeper. The Scorekeeper, for purposes of this Restated MAA, shall be the Funding Corporation.

Section 1.02. CIPA Oversight Body. The CIPA Oversight Body, for purposes of this Restated

MAA, shall be the same as the Oversight Body under Section 5.1 of CIPA.

Section 1.03. CIPA Scores. Net Composite Scores and Average Net Composite Scores, for purposes of this Restated MAA, shall be the same as those determined under Article II of CIPA and the Model referred to therein, as in effect on June 30, 2011, and as amended under CIPA or replaced by successor provisions under CIPA in the future, to the extent such future amendments or replacements are by agreement of all the Banks.

Section 1.04. Net Collateral and Permanent Capital Ratios. Each Bank shall report to the Scorekeeper within fifteen days after the end of each month its Net Collateral Ratio and Permanent Capital Ratio as of the last day of that month. Should any Bank later correct or revise, or be required to correct or revise, any past financial data in a way that would cause any Net Collateral Ratio or Permanent Capital Ratio previously reported hereunder to have been different, the Bank shall promptly report a revised Ratio to the Scorekeeper. Should the Scorekeeper consider it necessary to verify any Net Collateral Ratio or Permanent Capital Ratio, it shall so report to the Committee, or, if the Committee is not in existence, to the CIPA Oversight Body, and the Committee or the CIPA Oversight Body, as the case may be, may verify the Ratios as it deems appropriate, through reviews of Bank records by its designees (including experts or consultants retained by it) or otherwise. The reporting Bank shall cooperate in any such verification, and the other Banks shall provide such assistance in conducting any such verification as the Committee or the CIPA Oversight Body, as the case may be, may reasonably request.

Section 1.05. Category I. A Bank shall be in Category I if it (a) has an Average Net Composite Score of 50.0 or more, but less than 60.0, for the most recent calendar quarter for which an Average Net Composite Score is available, (b) has a Net Composite Score of 45.0 or more, but less than 60.0, for the most recent calendar quarter for which a Net Composite Score is available, (c) has a Net Collateral Ratio of 103.00% or more, but less than the greater of: (i) 104.00%, or (ii) 50 basis points above the minimum set by FCA for the last day of the most recent month or (d) has a Permanent Capital Ratio of 7.00% or more, but less than 8.00%, for the period ending on the last day of the most recent month.

Section 1.06. Category II. A Bank shall be in Category II if it (a) has an Average Net Composite Score of 35.0 or more, but less than 50.0, for the most recent calendar quarter for which an Average Net Composite Score is available, (b) has a Net Composite Score of 30.0 or more, but less than 45.0, for the most recent calendar quarter for which a Net Composite Score is available,(c) has a Net Collateral Ratio of 102.00% or more, but less than 103.00%, for the last day of the most recent month, (d) has a Permanent Capital Ratio of 5.00% or more, but less than 7.00%, for the period ending on the last day of the most recent month, or (e) is in Category I and has failed to provide information to the Committee as required by Article III within two Business Days after receipt of written notice from the Committee of such failure.

Section 1.07. Category III. A Bank shall be in Category III if it (a) has an Average Net Composite Score of less than 35.0 for the most recent calendar quarter for which an Average Net Composite Score is available, (b) has a Net Composite Score of less than 30.0 for the most recent calendar quarter for which a Net Composite Score is available, (c) has a Net Collateral Ratio of less than 102.00% for the last day of the most recent month, (d) has a Permanent Capital Ratio of less than 5.00% for the period ending on the last day of the most recent month, or (e) is in Category II and has failed to provide information to the Committee as required by Article III within two Business Days after receipt of written notice from the Committee of such failure.

Section 1.08. Highest Category. If a Bank would come within more than one Category by reason

of the various provisions of Sections 1.05 through 1.07, it shall be considered to be in the highest-numbered Category for which it qualifies (e.g., Category III rather than Category II).

Section 1.09. Notice by Scorekeeper. Within twenty days of the end of each month, after receiving the reports due under Section 1.04 within fifteen days of the end of the prior month, the Scorekeeper shall provide to all Banks, all Associations discounting with or otherwise receiving funding from a Bank that is in Category I, Category II or Category III, FCA, the Insurance Corporation, the Funding Corporation, and either the CIPA Oversight Body or, if it is in existence, the Committee a notice identifying the Banks, if any, that are in Categories I, II and III, or stating that no Banks are in such Categories.

ARTICLE II—THE COMMITTEE

Section 2.01. Formation. A Monitoring and Advisory Committee (the "Committee") shall be formed at the instance of the CIPA Oversight Body within seven days of the date that it receives a notice from the Scorekeeper under Section 1.09 that any Bank is in Category I, Category II or Category III (unless such a Committee is already in existence). The Committee shall remain in existence thereafter for so long as the most recent notice from the Scorekeeper under Section 1.09 indicates that any Bank is in Category I, Category II or Category III. If not already in existence, the Committee may also be formed (a) at the instance of the CIPA Oversight Body at any other time, in order to consider a Continued Access Request that has been submitted or is expected to be submitted, (b) for purposes of preparing the reports described in Section 7.05, and (c) as provided for in Section 8.04(b).

Section 2.02. Composition. The Committee shall be made up of two representatives of each Bank and two representatives of the Funding Corporation. One of the representatives of each Bank shall be that Bank's representative on the CIPA Oversight Body. The other representative of each Bank shall be an individual designated by the Bank's board of directors, who may be a member of the Bank's board of directors or a senior officer of the Bank, in the discretion of the Bank's board. One of the representatives of the Funding Corporation shall be an outside director of the Funding Corporation designated by the Funding Corporation board of directors. The other representative of the Funding Corporation shall be designated by the board of directors of the Funding Corporation from among the members of its board and/or its senior officers. The removal and replacement of the Committee members designated directly by Bank boards of directors and by the Funding Corporation shall be in the sole discretion of each Bank board and of the Funding Corporation, respectively. A replacement for a member of the CIPA Oversight Body shall automatically replace such member on the Committee.

Section 2.03. Authority and Responsibilities. The Committee shall have the authority and responsibilities specified in this Article II, in Sections 1.04, 3.01, 3.02, 3.05, 3.06, 4.02, 7.05, 8.04 and 8.08, and in Article VI, and such incidental powers as are necessary and appropriate to effectuating such authority and responsibilities.

Section 2.04. Meetings. Notwithstanding anything herein to the contrary, at all times, the Banks entitled to vote on Committee business shall be all Banks other than (i) those in Category II and Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and (ii) in the case of a Bank requesting a Continued Access Decision, such Bank. The initial meeting of the Committee shall be held at the call of the Chairman of the CIPA Oversight Body or a majority of the Parties entitled to vote on Committee business. Thereafter, the Committee shall meet at such times and such places at the call of the Chairman of the Committee or a majority of the Parties entitled to vote on Committee business. For all voting and quorum purposes each Party entitled to vote on Committee business shall act through at least one of its representatives. Written notice of each meeting shall be given to each member by the

Chairman or his or her designee not less than 48 hours prior to the time of the meeting. A meeting may be held without such notice upon the signing of a waiver of notice by all of the Parties entitled to vote on Committee business. All of the Parties entitled to vote on Committee business shall constitute a quorum for the conduct of business. A meeting may be held by a telephone conference arrangement or similar communication method allowing each speaker to be heard by all others in attendance at the same time.

Section 2.05. Action Without a Meeting. Action may be taken by the Committee without a meeting if each Bank and the Funding Corporation consent in writing to consideration of a matter without a meeting and all of the Parties entitled to vote on Committee business approve the action in writing, which writings shall be kept with the minutes of the Committee.

Section 2.06. Voting. The Funding Corporation and each Bank entitled to vote on Committee business shall have one vote on Committee business. Voting on Committee business (including recommendations on Continued Access Decisions, but not the ultimate vote on Continued Access Decisions, which is addressed in Article VI) shall be by unanimity of the Parties entitled to vote on Committee business that are present (physically, by telephone conference or similar communication method allowing each speaker to be heard by all others in attendance at the same time) through at least one representative. If a Bank or the Funding Corporation has two representatives present, they shall agree in casting the vote of the Bank or the Funding Corporation, and if they cannot agree on a particular matter, that Bank or the Funding Corporation shall not cast a vote on that matter, and, in determining unanimity, shall not be counted as a Party entitled to vote on that matter.

Section 2.07. Officers. The Committee shall elect from among its members a Chairman, a Vice Chairman, a Secretary and such other officers as it shall from time to time deem appropriate. The Chairman shall chair the meetings of the Committee and have such other duties as the Committee may delegate to him or her. The Vice Chairman shall perform such duties of the Chairman as the Chairman is unable or fails to perform, and shall have such other duties as the Committee may delegate to him or her. The Secretary shall keep the minutes and maintain the minute book of the Committee. Other officers shall have such duties as the Committee may delegate to them. Should the Chairman be a representative of either a Category II or Category III Bank, such individual will no longer be eligible to serve as Chairman. The Vice Chairman will thereafter perform the duties of Chairman, and if the Vice Chairman is unable, the Committee may elect a new Chairman from among its members.

Section 2.08. Retention of Staff, Consultants and Experts. The Committee shall be authorized to retain staff, consultants and experts as it deems necessary and appropriate in its sole discretion.

Section 2.09. Expenses. Any compensation of each member of the Committee for time spent on Committee business and for his or her out-of-pocket expenses, such as travel, shall be paid by the Party that designated that member to the Committee or to the CIPA Oversight Body. All other expenses incurred by the Committee shall be borne by the Banks and assessed by the Funding Corporation based on the formula then used by the Funding Corporation to allocate its operating expenses.

Section 2.10. Custody of Records. All information received by the Committee pursuant to this Restated MAA, and all Committee minutes, shall be lodged, while not in active use by the Committee, at the Funding Corporation, and shall be deemed records of the Funding Corporation for purposes of FCA examination. The Parties agree that documents in active use by the Committee may also be examined by FCA.

ARTICLE III - PROVISION OF INFORMATION

Section 3.01. Information To Be Provided By All Banks in Categories I, II and III. If a Bank is in Category I, Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and if the prior monthly notice by the Scorekeeper did not indicate that the Bank was in any Category, then the Bank shall within thirty days of receipt of the latest notice provide to the Committee: (a) a detailed explanation of the causes of its being in that Category, (b) an action plan to improve its financial situation so that it is no longer in any of the three Categories, (c) a timetable for achieving that result, (d) at the discretion of the Committee, the materials and information listed in Attachment 1 hereto (in addition to fulfilling the other obligations specified in Attachment 1 hereto) and (e) such other pertinent materials and information as the Committee shall, within seven days of receiving notice from the Scorekeeper, request in writing from the Bank. Such Bank shall summarize, aggregate or analyze data, as well as provide raw data, in such manner as the Committee may request. Such information shall be promptly updated (without any need for a request by the Committee) whenever the facts significantly change, and shall also be updated or supplemented as the Committee so requests in writing of the Bank by such deadlines as the Committee may reasonably specify.

Section 3.02. Additional Information To Be Provided By Banks in Categories II and III. If a Bank is in Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and if the prior monthly notice by the Scorekeeper did not indicate that the Bank was in Category II or Category III, then the Bank shall within thirty days of receipt of the latest notice provide to the Committee, in addition to the information required by Section 3.01, at the discretion of the Committee, the materials and information listed in Attachment 2 hereto (in addition to fulfilling the other obligations specified in Attachment 2 hereto). Such information shall be promptly updated (without any need for a request by the Committee) whenever the facts significantly change, and shall also be updated or supplemented as the Committee so requests in writing of the Bank by such deadlines as the Committee may reasonably specify.

Section 3.03. Documents or Information Relating to Communications With FCA or the Insurance Corporation. Notwithstanding Sections 3.01 and 3.02, a Bank shall not disclose to the Committee any communications between the Bank and FCA or the Insurance Corporation, as the case may be, or documents describing such communications, except as consented to by, and subject to such restrictive conditions as may be imposed by, FCA or the Insurance Corporation, as the case may be. However, facts regarding the Bank's condition or plans that pre-existed a communication with FCA or the Insurance Corporation and then were included in such a communication are not barred from disclosure by this section. The Committee shall decide on a case-by-case basis whether to request copies of such communications and documents from FCA or the Insurance Corporation, as the case may be. Each Bank hereby consents to the disclosure of such communications and documents to the Committee if consented to by FCA or the Insurance Corporation, as the case may be. Nothing in this section shall preclude a Bank from making disclosures to the System Disclosure Agent necessary to allow the System Disclosure Agent to comply with its obligations under the securities laws or other applicable law or regulations with regard to disclosure to investors.

Section 3.04. Sources of Information; Certification. Information provided to the Committee under Sections 3.01 and 3.02 shall, to the extent applicable, be data used in the preparation of financial statements in accordance with generally accepted accounting principles, or data used in the preparation of call reports submitted to FCA pursuant to 12 C.F.R. pt. 621, as amended from time to time, or any successor thereto. A Bank shall certify, through its chief executive officer or, if there is no chief executive officer, a senior executive officer, the completeness and accuracy of all information provided to the Committee under Sections 3.01 and 3.02.

Section 3.05. Failure to Provide Information. If a Bank fails to provide information to the

Committee as and when required under Sections 3.01 and 3.02, and does not correct such failure within two Business Days of receipt of the written notice by the Committee of the failure, then the Committee shall so advise the Scorekeeper.

Section 3.06. Provision of Information to Banks. Any information provided to the Committee under Sections 3.01 and 3.02 shall be provided by the Committee to any Bank upon request. A Bank shall not have the right under this Restated MAA to obtain information directly from another Bank.

Section 3.07. Cessation of Obligations. A Bank's obligation to provide information to the Committee under Section 3.01 shall cease as soon as the Bank is no longer in Category I, Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09. A Bank's obligation to provide to the Committee information under Section 3.02 shall cease as soon as the Bank is no longer in Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09.

ARTICLE IV - RESTRICTIONS ON MARKET ACCESS

Section 4.01. Final Restrictions. As of either,

(i) the tenth day after a Bank receives a notification from the Scorekeeper that it is in Category II, as indicated in the most recent notice from the Scorekeeper under Section 1.09, if it has not by said tenth day submitted a Continued Access Request to the Committee; or

(ii) if the Bank has submitted a Continued Access Request to the Committee by the tenth day after its receipt of notice from the Scorekeeper that it is in Category II, the seventh day following the day a submitted Continued Access Request is denied,

a Bank in Category II, as indicated in the most recent notice from the Scorekeeper under Section 1.09, (a) shall be permitted to participate in issues of Debt Securities only to the extent necessary to roll over the principal (net of any original issue discount) of maturing debt, and (b) shall comply with the Additional Restrictions.

Section 4.02. Category II Interim Restrictions. From the day that a Bank receives a notice from the Scorekeeper that it is in Category II until: (a) ten days thereafter, if the Bank does not by that day submit a Continued Access Request to the Committee, or (b) if the Bank by such tenth day after it has received a notice from the Scorekeeper that it is in Category II does submit a Continued Access Request to the Committee, the seventh day following the day that notice is received by the Bank that the Continued Access Request is granted or denied, the Bank (i) may participate in issues of Debt Securities only to the extent necessary to roll over the principal (net of any original issue discount) of maturing debt unless the Committee, taking into account the criteria in Section 6.03, shall specifically authorize participation to a greater extent, and (ii) shall comply with the Additional Restrictions. Notwithstanding the foregoing, the Category II Interim Restrictions shall not go into effect if a Continued Access Request has already been granted in anticipation of the formal notice that the Bank is in Category II.

Section 4.03. FCA Action. The Final Restrictions and the Category II Interim Restrictions shall go into effect without the need for case-by-case approval by FCA.

Section 4.04. Cessation of Restrictions. The Final Restrictions and the Category II Interim Restrictions shall cease as soon as the Bank is no longer in Category II, as indicated in the most recent notice from the Scorekeeper under Section 1.09. The Bank shall continue, however, to be subject to such

other obligations under this Restated MAA as may apply to it by reason of its being in another Category.

Section 4.05. Relationship to the Joint and Several Liability Reallocation Agreement. A Category II Bank shall not be subject to the Final Restrictions and Category II Interim Restrictions, to the extent that the Final Restrictions and Category II Interim Restrictions would prohibit such Category II Bank from issuing debt required to fund such Category II Bank's liabilities and obligations under the Joint and Several Liability Reallocation Agreement, if and when the Joint and Several Liability Reallocation Agreement is in effect among the Parties.

ARTICLE V - PROHIBITION OF MARKET ACCESS

Section 5.01. Final Prohibition. As of either,

(i) the tenth day after a Bank receives a notification from the Scorekeeper that it is in Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, if it has not by said tenth day submitted a Continued Access Request to the Committee; or

(ii) if the Bank has submitted a Continued Access Request to the Committee by the tenth day after its receipt of notice from the Scorekeeper that it is in Category III, the seventh day following the day a submitted Continued Access Request is denied,

a Bank in Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, (a) shall be prohibited from participating in issues of Debt Securities, and (b) shall comply with the Additional Restrictions.

Section 5.02. Category III Interim Restrictions. From the day that a Bank receives a notice from the Scorekeeper that it is in Category III until: (a) ten days thereafter, if the Bank does not by that day submit a Continued Access Request to the Committee, or (b) if the Bank by such tenth day after it has received a notice from the Scorekeeper that it is in Category III does submit a Continued Access Request to the Committee, the seventh day following the day that notice is received by the Bank that the Continued Access Request is granted or denied, the Bank (i) may participate in issues of Debt Securities only to the extent necessary to roll over the principal (net of any original issue discount) of maturing debt, and (ii) shall comply with the Additional Restrictions. Notwithstanding the foregoing, the Category III Interim Restrictions shall not go into effect if a Continued Access Request has already been granted in anticipation of the formal notice that the Bank is in Category III.

Section 5.03. FCA Action. The Category III Interim Restrictions shall go into effect without the need for case-by-case approval by FCA. The Parties agree that the Final Prohibition shall go into effect without the need for approval by FCA; provided, however, that FCA may override the Final Prohibition, for such time period up to 60 days as FCA may specify (or, if FCA does not so specify, for 60 days), by so ordering before the date upon which the Final Prohibition becomes effective pursuant to Section 5.01, and may renew such an override once only, for such time period up to 60 additional days as FCA may specify (or, if FCA does not so specify, for 60 days), by so ordering before the expiration of the initial override period. If the Final Prohibition is overridden by FCA, the Category III Interim Restrictions shall remain in effect.

Section 5.04. Cessation of Restrictions. The Final Prohibition and the Category III Interim Restrictions shall cease as soon as the Bank is no longer in Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09. The Bank shall continue, however, to be subject to such other obligations under this Restated MAA as may apply to it by reason of its being in another Category.

Section 5.05. Relationship to the Joint and Several Liability Reallocation Agreement. A Category III Bank shall not be subject to the Final Prohibition or Category III Interim Restrictions, to the extent that the Final Prohibition or Category III Interim Restrictions would prohibit such Category III Bank from issuing debt required to fund such Category III Bank's liabilities and obligations under the Joint and Several Liability Reallocation Agreement, if and when the Joint and Several Liability Reallocation Agreement is in effect among the Parties.

ARTICLE VI - CONTINUED ACCESS DECISIONS

Section 6.01. Process. The process for action on Continued Access Requests shall be as follows:

(a) Submission of Request. A Bank may submit a Continued Access Request for consideration by the Committee at any time, including (i) prior to formal notice from the Scorekeeper that it is in Category II or Category III, if the Bank anticipates such notice, and (ii) prior to the tenth day after a Bank receives a notification from the Scorekeeper that it is in Category II or the tenth day after a Bank receives a notification from the Scorekeeper that it is in Category III.

(b) Committee Recommendation. After a review of the Request, the supporting information and any other pertinent information available to the Committee, the Committee shall arrive at a recommendation regarding the Request (including, if the recommendation is to grant the Request, recommendations as to the expiration date of the Continued Access Decision and as to any conditions to be imposed on the Decision). The Funding Corporation, drawing upon its expertise and specialized knowledge, shall provide to the Committee all pertinent information in its possession (and the Banks authorize the Funding Corporation to provide such information to the Committee for its use as provided herein, and, to that limited extent only, waive their right to require the Funding Corporation to maintain the confidentiality of such information). The Committee shall send its recommendation and a statement of the reasons therefor, including a description of any considerations that were expressed for and against the recommendation by members of the Committee during its deliberations, together with the Request, the supporting information, a report of how the members of the Committee voted on the recommendation, a report by the Funding Corporation concerning its position on the recommendation, and any other material information that was considered by the Committee, to all Banks and the Funding Corporation by a nationally recognized overnight delivery service within fourteen days after receiving the Request. If the Committee fails to act within such fourteen-day period, the Continued Access Request shall be deemed forwarded to all Banks entitled to vote thereon for their consideration. If the Committee has failed to act, the Funding Corporation shall send to all Banks, within two days following the deadline for Committee action, a report concerning the position of the Funding Corporation on the Continued Access Request.

(c) Vote on the Request. Unless otherwise expressly stated herein, the Banks entitled to vote on the Request shall be all Banks other than those in Category II and Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and other than the Bank requesting the Continued Access Decision. Within ten days of receiving the Committee's recommendation and the accompanying materials (or, if the Committee failed to act within fourteen days, within ten days following the fourteenth day), the board of directors of each Bank entitled to vote on the Request, or its designee, after review of the recommendation, the accompanying materials, the report of the Funding Corporation, and any other pertinent information, shall vote to grant or deny the Request (as modified or supplemented by any recommendations of the Committee as to the expiration date of the Continued Access Decision and as to conditions to be imposed on the Decision), and shall provide written notice of its vote to the Committee. If the Committee has recommended in favor of a Continued Access Decision, the vote of a Bank shall be either to accept or reject the Committee's recommendation, including the recommended expiration date

and conditions; if the Committee has recommended against a Continued Access Decision or has failed to act, the vote of a Bank shall be either to grant the Continued Access Request on the terms requested by the requesting Bank, or to deny it. Failure to vote within the ten-day period shall be considered a "no" vote. A Continued Access Request shall be granted only upon a 100% Vote within the ten-day period, and shall be considered denied if a 100% Vote is not forthcoming by that day.

(d) Notice. The Committee shall promptly provide written notice to the Parties, FCA and the Insurance Corporation of the granting or denial of the Continued Access Request, and, if the Continued Access Request was granted, of all the particulars of the Continued Access Decision.

Section 6.02. Provision of Information to FCA and the Insurance Corporation. FCA and the Insurance Corporation shall be advised by the Committee of the submission of a Continued Access Request, shall be provided by the Committee with appropriate materials relating to the Request, and shall be advised by the Committee of the recommendation made by the Committee concerning the Request.

Section 6.03. Criteria. The Committee, in arriving at its recommendation on a Continued Access Request, and the voting Banks, in voting on a Continued Access Request, shall consider (a) the present financial strength of the Bank in issue, (b) the prospects for financial recovery of the Bank in issue, (c) the probable costs of particular courses of action to the Banks and the Insurance Fund, (d) any intentions expressed by the Insurance Corporation with regard to assisting or working with the Bank in issue, (e) any existing lending commitments and any particular high-quality new lending opportunities of the Bank, (f) seasonal variations in the borrowing needs of the Bank, (g) whether the Bank's independent public accountants have included a Going Concern Qualification in the most recent combined financial statements of the Bank and its constituent Associations, and (h) any other matters deemed pertinent.

Section 6.04. Expiration Date. A Continued Access Decision shall have such expiration date as the Committee recommends and is approved by a 100% Vote. If the Committee recommends against or fails to act on a Continued Access Request, and it is subsequently approved by a 100% Vote, the expiration date of the Continued Access Decision shall be the earlier of the date requested by the Bank or 180 days from the date the Request is granted. A Continued Access Decision may be terminated prior to that date, or renewed for an additional term, upon a new recommendation by the Committee and 100% Vote.

Section 6.05. Conditions. A Continued Access Decision shall be subject to such conditions as the Committee recommends and are approved by a 100% Vote. If specifically approved by a 100% Vote, administration of the details of the conditions and ongoing refinement of the conditions to take account of changing circumstances can be left to the Committee or such subcommittee as it may establish for that purpose. Among the conditions that may be imposed on a Continued Access Decision are (a) a requirement of remedial action by the Bank, failing which the Continued Access Decision will terminate, (b) a requirement of other appropriate conduct on the part of the Bank (such as compliance with the Additional Restrictions), failing which the Continued Access Decision will terminate, and (c) specific restrictions on continued borrowing by the Bank, such as a provision allowing a Bank in Category II to borrow only for specified types of business in addition to rolling over the principal of maturing debt, or allowing such a Bank only to roll over interest on maturing debt in addition to rolling over the principal of maturing debt, or a provision allowing a Bank in Category III to roll over a portion of its maturing debt. The Committee shall be responsible for monitoring and determining compliance with conditions, and shall promptly advise the Parties of any failure by a Bank to comply with conditions. The Committee's determination with respect to compliance with conditions shall be final, until and unless overturned or modified in arbitration pursuant to Section 7.08.

Section 6.06. FCA Action. The Parties agree that a Continued Access Decision shall go into effect without the need for approval by FCA, but that FCA may override the Continued Access Decision, for such time period as FCA may specify (or, if FCA does not so specify, until a new Continued Access Decision is made pursuant to a recommendation of the Committee and a 100% Vote, in which case it is again subject to override by FCA), by so ordering at any time.

Section 6.07. Notice to FCA of Intent to File Continued Access Request. A Bank that receives notice that it is in Category III shall advise FCA, within ten days of receiving such notice, whether it intends to file a Continued Access Request.

ARTICLE VII - OTHER

Section 7.01. Conditions Precedent. This Restated MAA shall go into effect on January 1, 2012, provided, however, that on or before January 15, 2012 each Party has executed a certificate in substantially the form of Attachment 3 hereto that all of the following conditions precedent have been satisfied: (a) the delivery to the Banks of an opinion by an outside law firm reasonably acceptable to all of the Parties and in substantially the form of Attachment 4 hereto, (b) the delivery to the Funding Corporation of an opinion by an outside law firm reasonably acceptable to all of the Parties and in substantially the form of Attachment 5 hereto, (c) adoption by each of the Banks and the Funding Corporation of a resolution in substantially the form of Attachment 6 hereto, (d) action by the Insurance Corporation, through its board, expressing its support for this Restated MAA, and (e) action by FCA, through its board, approving this Restated MAA pursuant to Section 4.2(c) and Section 4.2(d) of the Act, and (without necessarily expressing any view as to the proper interpretation of Section 4.9(b)(2) of the Act) approving this Restated MAA pursuant to Section 4.9(b)(2) of the Act insofar as such approval may be required, which action shall (i) indicate that the entry into and compliance with this Restated MAA by the Funding Corporation fully satisfy such obligations as the Funding Corporation may have with respect to establishing "conditions of participation" for market access under Section 4.9(b)(2), and (ii) contain no reservations or other conditions or qualifications except for those which may be specifically agreed to by the Funding Corporation's board of directors and the other Parties.

Upon execution of its certificate, each Party shall forward a copy to the Funding Corporation, attn. General Counsel, which shall advise all other Parties when a complete set of certificates is received.

If this Restated MAA becomes effective in accordance with this Section 7.01, the First Restated MAA shall be amended and restated by this Restated MAA as of that date without further action of the Parties. If any term, provision, covenant or restriction of this Restated MAA is held by a court of competent jurisdiction or other authority to be invalid, void or unenforceable, the remainder of the terms, provisions, covenants and restrictions of this Restated MAA shall remain in full force and effect and shall in no way be affected, impaired or invalidated. If any term, provision, covenant or restriction of this Restated MAA that purports to amend a term, provision, covenant or restriction of the Original Agreement or the First Restated MAA is held by a court of competent jurisdiction or other authority to be invalid, void or unenforceable, such term, provision, covenant or restriction of the Original Agreement or the First Restated MAA shall be considered to have continued and to be continuing in full force and effect at all times since this Restated MAA has purported to be in effect. The Parties agree that notwithstanding the occurrence of any of the foregoing events they will treat, to the maximum extent permitted by law, all actions theretofore taken pursuant to this Restated MAA as valid and binding actions of the Parties.

Section 7.02. Representations and Warranties. Each Party represents and warrants to the other Parties that (a) it has duly executed and delivered this Restated MAA, (b) its performance of this Restated MAA in accordance with its terms will not conflict with or result in the breach of or violation of any of

the terms or conditions of, or constitute (or with notice or lapse of time or both constitute) a default under any order, judgment or decree applicable to it, or any instrument, contract or other agreement to which it is a party or by which it is bound, (c) it is duly constituted and validly existing under the laws of the United States, (d) it has the corporate and other authority, and has obtained all necessary approvals, to enter into this Restated MAA and perform all of its obligations hereunder, and (e) its performance of this Restated MAA in accordance with its terms will not conflict with or result in the breach of or violation of any of the terms or conditions of, or constitute (or with notice or lapse of time or both constitute) a default under its charter (with respect to the Banks), or its bylaws.

Section 7.03. Additional Covenants.

(a) Each Bank agrees to notify the other Parties and the Scorekeeper if, at any time, it anticipates that within the following three months it will come to be in Category I, Category II or Category III, or will move from one Category to another.

(b) Whenever a Bank is subject to Final Restrictions, a Final Prohibition, Category II Interim Restrictions, Category III Interim Restrictions, or a Continued Access Decision, the Committee shall promptly so notify the Funding Corporation, and the Funding Corporation shall take all necessary steps to ensure that the Bank participates in issues of Debt Securities only to the extent permitted thereunder. The Funding Corporation may rely on the determination of the Committee as to whether a Bank has complied with a condition to a Continued Access Decision.

(c) Each Bank agrees that it will not at any time that it is in Category I, Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and will not without twelve months' prior notice to all other Banks and the Funding Corporation at any other time, either (i) withdraw, or (ii) modify, in a fashion that would impede the issuance of Debt Securities, the funding resolution it has adopted pursuant to Section 4.4(b) of the Act. Should a violation of this covenant be asserted, and should the Bank deny same, the funding resolution shall be deemed still to be in full effect, without modification, until arbitration of the matter is completed, and each Bank, by entering into this Restated MAA, consents to emergency injunctive relief to enforce this provision. Nothing in this Restated MAA shall be construed to restrict any Party's ability to take the position that a Bank's withdrawal or modification of its funding resolution is not authorized by law.

(d) Each Bank agrees that it will not at any time that it is in Category I, Category II or Category III, as indicated in the most recent notice from the Scorekeeper under Section 1.09, and will not without twelve months' prior notice to all other Banks and the System Disclosure Agent at any other time, fail to report information to the System Disclosure Agent pursuant to the Disclosure Program for the issuance of Debt Securities and for the System Disclosure Agent to have a reasonable basis for making disclosures pursuant to the Disclosure Program. Should the System Disclosure Agent assert a violation of this covenant, and should the Bank deny same, the Bank shall furnish such information as the System Disclosure Agent shall request until arbitration of the matter is completed, and each Bank, by entering into this Restated MAA, consents to emergency injunctive relief to enforce this provision. Nothing in this Restated MAA shall be construed to restrict the ability of the System Disclosure Agent to comply with its obligations under the securities laws or other applicable law or regulations with regard to disclosure to investors.

(e) Without implying that suit may be brought on any other matter, each Bank and the Funding Corporation specifically agree not to bring suit to challenge this Restated MAA or to challenge any Final Prohibition, Final Restrictions, Category II Interim Restrictions, Category III Interim Restrictions, Continued Access Decision, denial of a Continued Access Request or recommendation of the Committee

with respect to a Continued Access Request arrived at in accordance with this Restated MAA. This provision shall not be construed to preclude judicial actions under the U.S. Arbitration Act, 9 U.S.C. sections 1-15, to enforce or vacate arbitration decisions rendered pursuant to Section 7.08, or for an order that arbitration proceed pursuant to Section 7.08.

(f) The Funding Corporation agrees that it will not reinstitute the Market Access and Risk Alert Program, or adopt a similar such program for so long as both (i) this Restated MAA is in effect and (ii) Section 4.9(b)(2) of the Act is not amended in a manner which would require, nor is there any other change in applicable law or regulations which would require, the Funding Corporation to establish "conditions of participation" different from those contained in this Restated MAA. Should the condition described in (ii) no longer apply and the Funding Corporation adopt a market access program, this Restated MAA shall be deemed terminated. All Banks reserve the right to argue, if the conditions described in clauses (i) or (ii) of the preceding sentence should no longer apply and the Funding Corporation should adopt such a program, that any such program adopted by the Funding Corporation is contrary to law, either because Section 4.9(b)(2) of the Act does not authorize such a program, or for any other reason, and the entry by any Bank into this Restated MAA shall not be construed as waiving such right.

(g) It is expressly agreed that the Original Agreement, FCA approval of the Original Agreement, the First Restated MAA and FCA approval of this Restated MAA do not provide any grounds for challenging FCA or Insurance Corporation actions with respect to the creation of or the conduct of receiverships or conservatorships. Without limiting the preceding statement, each Bank specifically and expressly agrees and acknowledges that it cannot, and agrees that it shall not, attempt to challenge FCA's appointment of a receiver or conservator for itself or any other System institution or FCA's or the Insurance Corporation's actions in the conduct of any receivership or conservatorship (i) on the basis of this Restated MAA or FCA's approval of this Restated MAA; or (ii) on the grounds that Category II Interim Restrictions, Final Restrictions, Category III Interim Restrictions, or Final Prohibitions were or were not imposed, whether by reason of FCA's or the Insurance Corporation's action or inaction or otherwise. The Banks jointly and severally agree that they shall indemnify and hold harmless FCA and the Insurance Corporation against all costs, expenses, and damages, including without limitation, attorneys' fees and litigation costs, resulting from any such challenge by any Party.

Section 7.04. Termination. This Restated MAA shall terminate upon the earliest of (i) December 31, 2025, (ii) an earlier date if so agreed in writing by 100% Vote of the Banks, or (iii) in the event that all Banks shall be in either Category II or Category III. Commencing a year before December 31, 2025, the Parties shall meet to consider its extension. Except as provided in Section 7.03(f), it is understood that the termination of this Restated MAA shall not affect (i) any rights and obligations of the Funding Corporation under Section 4.9(b)(2) of the Act, and (ii) any Bank's rights pursuant to any Final Restrictions, a Final Prohibition, Category II Interim Restrictions, Category III Interim Restrictions, or a Continued Access Decision then-in-effect.

Section 7.05. Periodic Review. Commencing every third anniversary of the effective date of this Restated MAA, beginning January 1, 2015, and at such more frequent intervals as the Parties may agree, the Banks and the Funding Corporation, through their boards of directors, shall conduct a formal review of this Restated MAA and consider whether any amendments to it are appropriate. In connection with such review, the Committee shall report to the boards on the operation of the Restated MAA and recommend any amendments it considers appropriate.

Section 7.06. Confidentiality. The Parties may disclose this Restated MAA and any amendments to it and any actions taken pursuant to this Restated MAA to restrict or prohibit borrowing by a Bank. All

other information relating to this Restated MAA shall be kept confidential and shall be used solely for purposes of this Restated MAA, except that, to the extent permitted by applicable law and regulations, such information may be disclosed by (a) the System Disclosure Agent under the Disclosure Program, (b) a Bank, upon coordination of such disclosure with the System Disclosure Agent, as the Bank deems appropriate for purposes of the Bank's disclosures to borrowers or shareholders; (c) a Bank as deemed appropriate for purposes of disclosure to transacting parties (subject, to the extent the Bank reasonably can obtain such agreement, to such a transacting party's agreeing to keep the information confidential) of material information relating to that Bank, or (d) any Party in order to comply with legal or regulatory obligations. Notwithstanding the preceding sentence, the Parties shall make every effort, to the extent consistent with legal requirements, securities disclosure obligations and other business necessities, to preserve the confidentiality of information provided to the Committee by a Bank and designated as "Proprietary and Confidential." Any expert or consultant retained in connection with this Restated MAA shall execute a written undertaking to preserve the confidentiality of any information received in connection with this Restated MAA. Notwithstanding the foregoing, nothing in this Restated MAA shall prevent Parties from disclosing information to FCA or the Insurance Corporation.

Section 7.07. Amendments. This Restated MAA may be amended only by the written agreement of all the Parties.

Section 7.08. Dispute Resolution. All disputes between or among Parties relating to this Restated MAA shall be submitted to final and binding arbitration pursuant to the U.S. Arbitration Act, 9 U.S.C. sections 1-15, provided, however, that any recommendation by the Committee regarding a Continued Access Request (including, if the recommendation is to grant the Request, recommendations as to the expiration date of the Continued Access Decision and as to any conditions to be imposed on the Decision), and any vote by a Bank on a Continued Access Request, shall be final and not subject to arbitration. Arbitrations shall be conducted under the Commercial Arbitration Rules of the American Arbitration Association before a single arbitrator. An arbitrator shall be selected within fourteen days of the initiation of arbitration by any Party, and the arbitrator shall render a decision within thirty days of his or her selection, or as otherwise agreed to by the parties thereto.

Section 7.09. Governing Law. This Restated MAA shall be governed by and construed in accordance with the Federal laws of the United States of America, and, to the extent of the absence of Federal law, in accordance with the laws of the State of New York excluding any conflict of law provisions that would cause the law of any jurisdiction other than New York to be applied; provided, however, that in the event of any conflict between the U.S. Arbitration Act and applicable Federal or New York law, the U.S. Arbitration Act shall control.

Section 7.10. Notices. Any notices required or permitted under this Restated MAA shall be in writing and shall be deemed given if delivered in person, by e-mail, by fax or by a nationally recognized overnight courier, in each case addressed as follows, unless such address is changed by written notice hereunder:

To AgFirst Farm Credit Bank:

AgFirst Farm Credit Bank
Farm Credit Bank Building
1401 Hampton Street
Columbia, SC 29201
Attention: President and Chief Executive Officer
Fax: 803-254-1776
E-Mail:[OMITTED]

To AgriBank, FCB:

AgriBank, FCB
375 Jackson Street
St. Paul, MN 55101
Attention: President and Chief Executive Officer
Fax: 651-282-8494
E-Mail: [OMITTED]

To CoBank, ACB:

CoBank, ACB
5500 South Quebec Street
Greenwood Village, CO 80111
Attention: President and Chief Executive Officer
Fax: 303-740-4002
E-Mail: [OMITTED]

To the Farm Credit Bank of Texas:

Farm Credit Bank of Texas
4801 Plaza on the Lake Drive
Austin, TX 78746
Attention: President and Chief Executive Officer
Fax: 512-465-0775
E-Mail: [OMITTED]

To U.S. AgBank, FCB:

U.S. AgBank, FCB
Farm Credit Bank Building
245 North Waco
Wichita, KS 67202
Attention: President and Chief Executive Officer
Fax: 316-266-5126
E-Mail: [OMITTED]

To Federal Farm Credit Banks Funding Corporation:

Federal Farm Credit Banks Funding Corporation
10 Exchange Place
Suite 1401
Jersey City, NJ 07302
Attention: President and Chief Executive Officer
Fax: 201-200-8109

E-Mail: [OMITTED]

To the Farm Credit System Insurance Corporation:

Farm Credit System Insurance Corporation
1501 Farm Credit Drive
McLean, Virginia 22102
Attention: Chairman
Fax: 703-790-9088
E-Mail: [OMITTED]

To the Farm Credit Administration:

Farm Credit Administration
1501 Farm Credit Drive
McLean, Virginia 22102-5090
Attention: Chairman
Fax: 703-734-5784
E-Mail: [OMITTED]

To the CIPA Oversight Body:

At such address, fax number and e-mail address as shall be supplied to the Parties from time to time by the Chairman of the CIPA Oversight Body.

To the Committee:

At such address, fax number and e-mail address as shall be supplied by the Committee, which the Committee shall promptly transmit to each Party.

Any notice sent by the courier shall be deemed given one Business Day after depositing with the overnight courier. Any notice given in person, by e-mail, or by fax shall be deemed given instantaneously.

Section 7.11. Headings; Conjunctive/Disjunctive; Singular/Plural. The headings of any article or section of this Restated MAA are for convenience only and shall not be used to interpret any provision of the Restated MAA. Uses of the conjunctive include the disjunctive, and vice versa, unless the context clearly requires otherwise. Uses of the singular include the plural, and vice versa, unless the context clearly requires otherwise.

Section 7.12. Successors and Assigns. Except as provided in the definitions of "Bank" and "Banks" in Article IX, this Restated MAA shall inure to the benefit of and be binding upon the successors and assigns of the Parties, including entities resulting from the merger or consolidation of one or more Banks.

Section 7.13. Counterparts. This Restated MAA, and any document provided for hereunder, may be executed in one or more counterparts. Transmission by facsimile or other form of electronic transmission of an executed counterpart of this Restated MAA shall be deemed to constitute due and sufficient delivery of such counterpart.

Section 7.14. Waiver. Any provision of this Restated MAA may be waived, but only if such waiver is in writing and is signed by all Parties to this Restated MAA.

Section 7.15. Entire Agreement. Except as provisions of CIPA are cited in this Restated MAA (which provisions are expressly incorporated herein by reference), this Restated MAA sets forth the entire agreement of the Parties and supersedes all prior understandings or agreements, oral or written, among the Parties with respect to the subject matter hereof.

Section 7.16. Relation to CIPA. This Restated MAA and CIPA are separate agreements, and invalidation of one does not affect the other. Should CIPA be invalidated or terminated, the Parties will take the necessary steps to maintain those aspects of CIPA that are referred to in Sections 1.01, 1.02 and 1.03 of this Restated MAA, and to replace the CIPA Oversight Body for purposes of continued administration of this Restated MAA.

Section 7.17. Third Parties. Except as provided in Sections 2.10, 3.03, 7.03(g), 7.21 and 7.22, this Restated MAA is for the benefit of the Parties and their respective successors and assigns, and no rights are intended to be, or are, created hereunder for the benefit of any third party.

Section 7.18. Time Is Of The Essence. Time is of the essence in interpreting and performing this Restated MAA.

Section 7.19. Statutory Collateral Requirement. Nothing in this Restated MAA shall be construed to permit a Bank to participate in issues of Debt Securities or other obligations if it does not satisfy the collateral requirements of Section 4.3(c) of the Act. For purposes of this Section, "Bank" shall include any System bank in conservatorship or receivership.

Section 7.20. Termination of System Status. Nothing in this Restated MAA shall be construed to preclude a Bank from terminating its status as a System institution pursuant to Section 7.10 of the Act, or from at that time withdrawing, as from that time forward, the funding resolution it has adopted pursuant to Section 4.4(b) of the Act. A Bank that terminates its System status shall cease to have any rights or obligations under this Restated MAA, except that it shall continue to be subject to Article VIII with respect to claims accruing through the date of such termination of System status.

Section 7.21. Restrictions Concerning Subsequent Litigation. It is expressly agreed by the Banks that (a) characterization or categorization of Banks, (b) information furnished to the Committee or other Banks, and (c) discussions or decisions of the Banks or Committee under this Restated MAA shall not be used in any subsequent litigation challenging FCA's or the Insurance Corporation's action or inaction.

Section 7.22. Effect of this Agreement. Neither this Restated MAA nor FCA approval hereof shall in any way restrict or qualify the authority of FCA or the Insurance Corporation to exercise any of the powers, rights, or duties granted by law to FCA or the Insurance Corporation.

Section 7.23. Relationship to the Joint and Several Liability Reallocation Agreement. This Restated MAA and the Joint and Several Liability Reallocation Agreement are separate agreements, and invalidation of one does not affect the other.

ARTICLE VIII - INDEMNIFICATION

Section 8.01. Definitions. As used in this Article VIII:

(a) "Indemnified Party" means any Bank, the Funding Corporation, the Committee, the Scorekeeper, or any of the past, present or future directors, officers, stockholders, employees or agents of the foregoing.

(b) "Damages" means any and all losses, costs, liabilities, damages and expenses, including, without limitation, court costs and reasonable fees and expenses of attorneys expended in investigation, settlement and defense (at the trial and appellate levels and otherwise), which are incurred by an Indemnified Party as a result of or in connection with a claim alleging liability to any non-Party for actions taken pursuant to or in connection with this Restated MAA. Except to the extent otherwise provided in this Article VIII, Damages shall be deemed to have been incurred by reason of a final settlement or the dismissal with prejudice of any such claim, or the issuance of a final nonappealable order by a court of competent jurisdiction which ultimately disposes of such a claim, whether favorably or unfavorably.

Section 8.02. Indemnity. To the extent consistent with governing law, the Banks, jointly and severally, shall indemnify and hold harmless each Indemnified Party against and in respect of Damages, provided, however, that an Indemnified Party shall not be entitled to indemnification under this Article VIII in connection with conduct of such Indemnified Party constituting gross negligence, willful misconduct, intentional tort or criminal act, or in connection with civil money penalties imposed by FCA. In addition, the Banks, jointly and severally, shall indemnify an Indemnified Party for all costs and expenses (including, without limitation, fees and expenses of attorneys) incurred reasonably and in good faith by an Indemnified Party in connection with the successful enforcement of rights under any provision of this Article VIII.

Section 8.03. Advancement of Expenses. The Banks, jointly and severally, shall advance to an Indemnified Party, as and when incurred by the Indemnified Party, all reasonable expenses, court costs and attorneys' fees incurred by such Indemnified Party in defending any proceeding involving a claim against such Indemnified Party based upon or alleging any matter that constitutes, or if sustained would constitute, a matter in respect of which indemnification is provided for in Section 8.02, so long as the Indemnified Party provides the Banks with a written undertaking to repay all amounts so advanced if it is ultimately determined by a court in a final nonappealable order or by agreement of the Banks and the Indemnified Party that the Indemnified Party is not entitled to be indemnified under Section 8.02.

Section 8.04. Assertion of Claim.

(a) Promptly after the receipt by an Indemnified Party of notice of the assertion of any claim or the commencement of any action against him, her or it in respect of which indemnity may be sought against the Banks hereunder (an "Assertion"), such Indemnified Party shall apprise the Banks, through a notice to each of them, of such Assertion. The failure to so notify the Banks shall not relieve the Banks of liability they may have to such Indemnified Party hereunder, except to the extent that failure to give such notice results in material prejudice to the Banks.

(b) Any Bank receiving a notice under paragraph (a) shall forward it to the Committee (which, if not in existence, shall be formed at the instance of such Bank to consider the matter). The Banks, through the Committee, shall be entitled to participate in, and to the extent the Banks, through the

Committee, elect in writing on thirty days' notice, to assume, the defense of an Assertion, at their own expense, with counsel chosen by them and satisfactory to the Indemnified Party. Notwithstanding that the Banks, through the Committee, shall have elected by such written notice to assume the defense of any Assertion, such Indemnified Party shall have the right to participate in the investigation and defense thereof, with separate counsel chosen by such Indemnified Party, but in such event the fees and expenses of such separate counsel shall be paid by such Indemnified Party and shall not be subject to indemnification by the Banks unless (i) the Banks, through the Committee, shall have agreed to pay such fees and expenses, (ii) the Banks shall have failed to assume the defense of such Assertion and to employ counsel satisfactory to such Indemnified Party, or (iii) in the reasonable judgment of such Indemnified Party, based upon advice of his, her or its counsel, a conflict of interest may exist between the Banks and such Indemnified Party with respect to such Assertion, in which case, if such Indemnified Party notifies the Banks, through the Committee, that such Indemnified Party elects to employ separate counsel at the Banks' expense, the Banks shall not have the right to assume the defense of such Assertion on behalf of such Indemnified Party. Notwithstanding anything to the contrary in this Article VIII, neither the Banks, through the Committee, nor the Indemnified Party shall settle or compromise any action or consent to the entering of any judgment (x) without the prior written consent of the other, which consent shall not be unreasonably withheld, and (y) without obtaining, as an unconditional term of such settlement, compromise or consent, the delivery by the claimant or plaintiff to such Indemnified Party of a duly executed written release of such Indemnified Party from all liability in respect of such Assertion, which release shall be satisfactory in form and substance to counsel to such Indemnified Party. The Funding Corporation shall not be entitled to vote on actions by the Committee under this paragraph (b) or Section 8.08.

Section 8.05. Remedies; Survival. The indemnification, rights and remedies provided to an Indemnified Party under this Article VIII shall be (i) in addition to and not in substitution for any other rights and remedies to which any of the Indemnified Parties may be entitled, under any other agreement with any other Person, or otherwise at law or in equity, and (ii) provided prior to and without regard to any other indemnification available to any Indemnified Party. This Article VIII shall survive the termination of this Restated MAA.

Section 8.06. No Rights in Third Parties. This Restated MAA shall not confer upon any Person other than the Indemnified Party any rights or remedies of any nature or kind whatsoever under or by reason of the indemnification provided for in this Article VIII.

Section 8.07. Subrogation; Insurance. Upon the payment by the Banks to an Indemnified Party of any amounts for which an Indemnified Party shall be entitled to indemnification under this Article VIII, if the Indemnified Party shall also have the right to recover such amount under any commercial insurance, the Banks shall be subrogated to such rights to the extent of the indemnification actually paid. Where coverage under such commercial insurance may exist, the Indemnified Party shall promptly file and diligently pursue a claim under said insurance. Any amounts paid pursuant to such claim shall be refunded to the Banks to the extent the Banks have provided indemnification payments under this Article VIII, provided, however, that recovery under such insurance shall not be deemed a condition precedent to the indemnification obligations of the Banks under this Article VIII.

Section 8.08. Sharing in Costs. The Banks shall share in the costs of any indemnification payment hereunder as the Committee shall determine.

ARTICLE IX - DEFINITIONS

The following definitions are used in this Restated MAA:

"Act" means the Farm Credit Act of 1971, 12 U.S.C. section 2001, et seq., as amended from time to time, or any successors thereto.

The "Additional Restrictions" are that a Bank (a) shall manage its asset/liability mix so as not to increase, and, to the extent possible, so as to reduce or eliminate, any Interest-Rate Sensitivity Deduction in its Net Composite Score, and (b) shall not increase the dollar amount of any liabilities, or take any action giving rise to a lien or pledge on its assets, senior to its liability on Debt Securities other than (i) tax liabilities and secured liabilities arising in the ordinary course of business through activities other than borrowing, such as mechanic's liens or judgment liens, and (ii) secured liabilities, or an action giving rise to such a lien or pledge, incurred in the ordinary course of business as the result of issuing secured debt or entering into repurchase agreements, provided, however, that such debt issuances and agreements may be undertaken to the extent that the proceeds therefrom are used to repay the principal of outstanding Debt Securities and the value of the collateral securing the debt issuances or the agreements (computed in the same manner as provided under Section 4.3(c) of the Act) does not exceed the amount of principal so repaid.

"Associations" means agricultural credit associations, federal land bank associations, federal land credit associations and production credit associations.

"Average Net Composite Score" is defined in Section 1.03.

"Bank" means a bank (including its consolidated subsidiaries) of the Farm Credit System, other than (except where noted) any bank in conservatorship or receivership (and its consolidated subsidiaries).

"Banks" means the banks (including their consolidated subsidiaries) of the Farm Credit System, other than (except where noted) any banks in conservatorship or receivership (and their consolidated subsidiaries).

"Business Day" means any day other than a Saturday, Sunday or Federal holiday.

"Business Plan" means the business plan required under 12 C.F.R. 618.8440, as amended from time to time, or any successors thereto.

"Category" means Category I, Category II, or Category III, as the circumstances require.

"Category I" is defined in Section 1.05.

"Category II" is defined in Section 1.06.

"Category II Interim Restrictions" means the requirements set forth in Section 4.02.

"Category III" is defined in Section 1.07.

"Category III Interim Restrictions" means the requirements set forth in Section 5.02.

"CIPA" means that certain Amended and Restated Contractual Interbank Performance Agreement among the Banks of the Farm Credit System and the Federal Farm Credit Banks Funding Corporation, the Scorekeeper, dated as of June 30, 2011, as amended from time to time, or any successor thereto.

"CIPA Oversight Body" is defined in Section 1.02.

"Collateral" is defined as in Section 4.3(c) of the Act and the regulations thereunder, as amended from time to time, or any successors thereto.

The "Committee" is defined in Section 2.01.

"Continued Access Decision(s)" means a decision, subject to the procedures, terms and conditions described in Article VI, that Final Restrictions or a Final Prohibition not go into effect, or be lifted.

"Continued Access Request" means a request for a Continued Access Decision.

"Days" means calendar days, unless the term Business Days is used.

"Debt Securities" means Systemwide and consolidated obligations issued through the Funding Corporation, within the meaning of Sections 4.2(c), 4.2(d) and 4.9 of the Act.

"Disclosure Program" means the program established, pursuant to resolutions of the Banks and the Funding Corporation adopted in 1987 and last substantively revised in 1994, for disclosure at the Systemwide level of financial and other information in connection with the issuance of Debt Securities, as amended from time to time, or any successor thereto.

"FCA" means the Farm Credit Administration.

"Final Prohibition" means the requirements set forth in Section 5.01.

"Final Restrictions" means the requirements set forth in Section 4.01.

"First Restated MAA" means that certain Amended and Restated Market Access Agreement, dated July 1, 2003, among the Banks and the Funding Corporation.

"Funding Corporation" means the Federal Farm Credit Banks Funding Corporation.

"Going Concern Qualification" means a qualification expressed pursuant to Statement of Auditing Standards No. 59, "The Auditor's Consideration of an Entity's Ability to Continue As a Going Concern."

"Insurance Corporation" means the Farm Credit System Insurance Corporation.

"Insurance Fund" means the Farm Credit Insurance Fund maintained by the Insurance Corporation pursuant to Section 5.60 of the Act.

"Interest-Rate Sensitivity Deduction" is defined as in Article II of CIPA, and the Model referred to therein, as amended from time to time, or any successor thereto.

"Joint and Several Liability Reallocation Agreement" means that certain Joint and Several Liability Reallocation Agreement among the Banks and the Funding Corporation.

"Liquidity Deficiency Deduction" is defined as in Article II of CIPA, and the Model referred to

therein, as amended from time to time, or any successor thereto.

"Model" means the term Model as it is defined in the CIPA.

"Net Collateral" means a Bank's collateral as defined in 12 C.F.R. 615.5050, as amended from time to time, or any successors thereto (except that eligible investments as described in 12 C.F.R. 615.5140, as amended from time to time, or any successors thereto, are to be valued at their amortized cost), less an amount equal to that portion of the allocated investments of affiliated Associations that is not counted as permanent capital by the Bank.

"Net Collateral Ratio" means a Bank's Net Collateral divided by Bank-only total liabilities (i.e., the total liabilities used to compute the net collateral ratio defined in 12 C.F.R. 615.5301(d), as amended from time to time or any successors thereto).

"Net Composite Score" is defined in Section 1.03.

"100% Vote" means an affirmative vote, through each voting Bank's board of directors or its designee, of all Banks that are entitled to vote on a matter.

"Original Agreement" means that certain Market Access Agreement, dated September 1, 1994 and effective as of November 23, 1994, among the Banks and the Funding Corporation.

"Parties" mean the parties to this Restated MAA. A bank in conservatorship or receivership is not a party to this Restated MAA.

"Permanent Capital" is defined as in Section 4.3A(a)(1) of the Act and the regulations thereunder, as amended from time to time, or any successors thereto.

"Permanent Capital Ratio" means a Bank's Permanent Capital as a percentage of its Risk-Adjusted Asset Base.

"Person" means any human being, partnership, association, joint venture, corporation, legal representative or trust, or any other entity.

"Ratio(s)" means either the Net Collateral Ratio, or Permanent Capital Ratio, as the circumstances require.

"Risk-Adjusted Asset Base" is defined as in 12 C.F.R. 615.5210(e), as amended from time to time, or any successor thereto.

"Scorekeeper" is defined in Section 1.01.

"System" means the Farm Credit System.

"System Disclosure Agent" means the Funding Corporation or such other disclosure agent as all Banks shall unanimously agree upon, to the extent permitted by law or regulation. For purposes of this definition, "Banks" shall include any System bank in conservatorship or receivership.

[end of Draft Second Amended and Restated MAA]

Date: October 27, 2011

Mary Alice Donner,
Acting Secretary,
Farm Credit Administration Board.

[1]68 FR 19539 (April 21, 2003).

[2]75 FR 76729 (December 9, 2010).

[3]12 U.S.C. 2155.

[4]75 FR 64727 (October 20, 2010).

[5]CoBank, ACB and U.S. Agbank, FCB plan to merge as of January 1, 2012. The FCA has preliminarily approved the merger, and the boards and stockholders of both banks have voted to approve the merger.

73 FR 33931, 06/16/2008

Handbook Mailing HM-08-5

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AC42

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Mission-Related Investments, Rural Community Investments

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA) proposes a new rule that would authorize each Farm Credit System (Farm Credit, System, or FCS) bank, association, and service corporation (institution) to invest in rural communities across America under certain conditions. The proposed rule would allow each System institution to make investments in rural communities that are outside of an urbanized area only for specific purposes. Several provisions in the proposed rule would ensure that System investments in rural America are safe and sound and comply with the Farm Credit Act of 1971, as amended (Act), and other applicable statutes.

DATES: Comments should be received on or before August 15, 2008.

ADDRESSES: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site or the Federal eRulemaking Portal. As faxes are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, please consider another means to submit your comment if possible. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.
- FAX: (703) 883-4477. Posting and processing of faxes may be delayed. Please consider another means to comment, if possible.

You may review copies of comments we receive at our office in McLean, Virginia, or from our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public

Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Laurie Rea, Associate Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA, (703) 883-4414, TTY (703) 883-4434;

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or

Richard A. Katz, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Background

The FCA proposes a new rule, § 615.5176, which would enable System institutions to more effectively serve the needs of rural communities by exercising investment powers under the Act. The proposed rule focuses on specific needs in rural communities. Essentially, the proposed rule would authorize two separate types of investments that System institutions could make in America's rural communities. First, System institutions could invest in debt securities that would involve projects or programs that benefit the public in rural communities. Equity investments in venture capital funds are the second type of investment that the proposed rule would authorize. Venture capital funds create new economic opportunities and jobs in rural communities by providing capital to small or start-up businesses.

The proposed rule would authorize each System institution to make investments in rural areas that according to the terms of the latest United States decennial census have fewer than 50,000 residents and are outside of an urbanized area. The proposed rule would allow System institutions to invest in: (1) Essential community facilities; (2) basic transportation infrastructure; (3) rural communities recovering from disasters; (4) debt securities for rural development projects that the United States, its agencies, any state, Puerto Rico, or a local municipal government sponsors or guarantees; (5) debt securities that support the rural development activities of non-System financial institutions; (6) rural business investment companies; and (7) venture capital funds that invest in rural businesses that create jobs and economic growth under specific conditions. The proposed rule also would allow System institutions to make other investments that are not expressly covered by this regulation with FCA approval. Under the proposed rule, an institution may hold rural community investments in an amount that does not exceed 150 percent of its total surplus. As discussed in greater detail below, other provisions of the proposed rule address safety and soundness and compliance with the Act.

A. The Statutory Basis for the Proposed Rule

System institutions derive their investment authorities from several provisions of the Act. Sections 1.5(15) and 3.1(13)(A) of the Act[1] authorize System banks to invest in securities of the United States and its agencies, and make "other investments as may be authorized under regulations issued by the Farm Credit Administration." Sections 2.2(10) and 2.12(18) of the Act[2] authorize System associations to invest their funds as approved by their district banks in accordance with FCA regulations. A System service corporation is authorized by section 4.25 of the Act[3] to engage in investment activities to the same extent as its System parents.[4]

Investments in rural communities are compatible with the System's statutory mandate. The preamble to the Act clearly states that Congress enacted the law "to provide for an adequate and flexible flow of money into rural areas, and to modernize . . . existing farm credit law to meet current and future rural credit needs, and for other purposes." The preamble and investment provisions of the Act form a broad statutory framework that confers considerable discretion on the FCA to decide the purposes, conditions, and limits for all investment activities at System institutions. In exercising this discretion, the FCA has authorized System institutions to invest their funds in obligations that are suitable for liquidity, risk management, and activities that are closely related to the System's statutory mandate.

In implementing the investment provisions of the Act, the FCA has taken a cautious and incremental approach in approving System investments for mission-related purposes. Since Congress enacted the Act in 1971, the FCA has approved new regulations and programs that authorize the System to make specified investments in agriculture and rural communities, subject to certain conditions and limits. The factors that the FCA considers whenever it decides to approve new mission-related investments are: (1) The financial needs of agriculture and rural communities; (2) new investment products offered in the marketplace; (3) the System's status as a Government-sponsored enterprise (GSE); and (4) compliance with the Act and other applicable statutes. Under FCA regulations and programs, System investments in agriculture and rural communities have remained small because lending to farmers, ranchers, cooperatives, and other eligible borrowers is the primary activity of System institutions under the Act. Additionally, most mission-related investments that the FCA has approved are related to the System's expertise in financing agriculture, rural housing, and infrastructure in rural areas.

Historically, the FCA has authorized System institutions to invest in debt securities, but not in equity securities of non-System entities. In 2002, Congress granted System institutions express authority to invest in rural business investment companies (RBICs), which are venture capital funds that the United States Department of Agriculture (USDA) funds and oversees. The FCA believes that allowing the System to invest in venture capital funds that hold small equity positions in start-up rural enterprises is consistent with congressional intent. As discussed in greater detail below, the proposed rule would implement the provisions of title VI of the Farm Security and Rural Investment Act of the 2002[5] and the Act by allowing System institutions to invest in RBICs and other venture capital funds that provide start-up money to rural entrepreneurs.

In accordance with the Act, the FCA has enacted several regulations since 1971 that authorize System investments in agriculture and America's rural communities. The first mission-related investments that the FCA approved were farmers' notes.[6] Since 1972, FCA regulations have authorized System banks and associations to invest in obligations of States, municipalities, and local governments. In 1993, a new regulation authorized System institutions to purchase and hold mortgage securities issued or guaranteed by the Federal Agricultural Mortgage Corporation (Farmer Mac). In 1999, the FCA amended another regulation to permit investment in asset securities backed by agricultural equipment. An existing regulation, § 615.5140(e), allows Farm Credit institutions to hold other investments that the FCA approves on a case-by-case basis. This regulatory framework guides investment practices at Farm Credit institutions and ensures that System investments comply with law and are safe and sound.

Since 2005, the FCA has approved requests by System banks and associations, on a case-by-case basis, to initiate pilot programs for investing in America's rural communities under specified conditions. Under these FCA-approved pilot programs, System institutions acquired expertise and became active in making investments that provided funding for essential projects in rural communities.

Based on the positive experience of these pilot programs, the FCA is proposing a rule that will allow all System banks, associations, and service corporations to make certain investments in rural communities under prescribed conditions without prior FCA approval. This proposed rule would permit the rural-based System to use its expertise and a portion of its financial resources to support rural economic growth and development by investing in those projects and programs in America's rural communities that often have difficulty attracting financing at affordable rates.

The proposed rule implements the investment provisions of the Act by ensuring that: (1) System institutions invest in rural communities only for specific purposes; and (2) all instruments purchased and held by Farm Credit institutions are investment securities in accordance with market practices and securities laws. Investments in rural communities also would be subject to a portfolio limit and other controls to ensure that FCS rural community investment activities comply with the Act and are safe and sound.

The FCA emphasizes that lending to farmers, ranchers, aquatic producers and harvesters, farm-related businesses, rural homeowners, cooperatives, and rural utilities remains the primary purpose of the System. However, within the parameters prescribed by the proposed rule, System investments, which help strengthen the economic viability of rural communities, are compatible with the preamble and several provisions of the Act. Investing in rural communities enables Farm Credit to fulfill its mission by helping sustain rural communities on which the System's borrowers and owners are dependent for their livelihoods.

B. <u>Why Investments in Rural Communities are Important</u>

The FCA proposes this rule to allow the System to make investments in rural communities and to support and supplement investments by government, commercial banks, investment banks, and venture capital funds. The FCA believes that this new rule will enable the System to more fully assist rural communities in financing projects that are designed to provide essential facilities, infrastructure, and services to residents. As discussed in greater detail below, System institutions made investments under FCA authorized pilot programs, which demonstrated that the FCS is both locally and regionally positioned to effectively participate and assist rural development networks that strive to address rural needs. The proposed rule is designed to enable FCS institutions to collaborate and partner in rural development initiatives that advance the System’s mission and its capacity to serve as a financial intermediary promoting the flow of money into rural areas.

Many rural communities are struggling to retain economic viability and vitality that can provide economic opportunities and a better quality of life for their residents. Rural communities face numerous demographic, social, and economic challenges in meeting the needs of their residents. As a result, rural communities often find it difficult to provide the essential facilities, infrastructure, and services that their residents need. For example, an aging population in rural areas requires medical and assisted health care facilities. However, rural communities often have fewer health care providers and facilities to meet the increasing medical needs of its growing elderly population.[7]

Also, a large gap persists between rural and metropolitan residents who have earned college

degrees. This gap is reinforced by a lower demand for workers with post-secondary degrees in rural areas, which in turn, contributes to the out-migration of skilled workers.[8] These factors place rural communities at a disadvantage in attracting businesses that offer higher wages and better job benefits to employees. Essential facilities, infrastructure, and services in rural areas often lag behind those in metropolitan areas. This is another factor that limits the ability of rural communities to attract and retain businesses that provide employment and economic opportunities. These obstacles to rural economic development and revitalization are further compounded by funding challenges for projects that are designed to assist rural communities in resolving these problems.

Funding for economic growth and development projects in rural communities is available from a variety of sources, most notably the Federal and State governments, and private-sector financiers, including commercial and investment banks. Each of these entities faces challenges in providing rural communities with the funding needed for these projects. Efforts by Federal or State governments to help rural communities are often curtailed by budget constraints. Also, many rural community banks are willing to provide short-term funding, but find it difficult to provide the additional long-term capital investment needed for facilities in rural areas.[9] Essential facilities and large capital improvements, such as critical care access hospitals, require a large capital investment that is repaid over an extended period of time. In many cases, no single investor is willing and able to supply all of the capital necessary for such projects, and rural communities must depend on a combination of government and private-sector financial sources and local donations.[10] Another obstacle is that rural development projects in remote rural locations typically involve higher costs and greater risks, which deter investors. For these reasons, government and private-sector financial resources often are insufficient to fully fund many necessary and worthwhile projects that rural residents need.

System institutions are an integral part of rural America. The farmers and ranchers who borrow from and own the FCS live and work in rural communities. These System stockholders and their families depend on local rural communities for essential services, employment, and other economic opportunities. Today, the majority of farm household income is derived from off-farm sources.[11] As a result, farm families depend on local rural communities for employment that supplements farm income. Further, agricultural production is one of the most hazardous industrial sectors.[12] Farmers and ranchers confront the same problems as other residents of America's rural communities in obtaining access to quality hospitals, medical facilities, schools and essential services.

System institutions are active in financial markets that serve regional and local rural areas across the United States. For this reason, the System is familiar with the challenges that rural communities face in meeting the needs of both farm and nonfarm rural residents. The System has the financial capacity to invest in rural development, and this proposed rule would advance the System's contributions to rural development efforts.

C. <u>Investments in Rural Communities Made Under Pilot Programs</u>

Over the past 3 years, a number of System institutions have developed programs to make investments in rural communities through FCA-approved pilot programs. As a result of the investments made under these pilot programs, rural communities were able to address specific regional needs because these investments provided greater access to capital for community facilities, revitalization projects, and other economic development initiatives. These investments also provided additional liquidity into rural financial markets. In several cases, these investments helped provide capital at more affordable terms and rates, which in turn made these projects more feasible.

The pilot programs have demonstrated that Farm Credit institutions have the capacity and

willingness to work collaboratively with rural communities and financial institutions to address local and regional rural economic development needs. As previously discussed, many rural development projects are reliant on multiple partners for success. In making rural community investments under the pilot programs, System institutions partnered with: Federal, State, and regional rural development authorities; non-System financial institutions including rural community banks; nonprofit organizations; and venture capital funds. For example, System investments under the pilot programs have provided capital for rural hospitals designated as critical access facilities, which were sponsored, in part, by the USDA's Rural Development Community Facilities Program. Other examples of specific System investments that have made a positive difference in rural communities include investments in: medical and mental clinics; treatment facilities for adolescents and adults; living and nursing centers for the elderly; schools; and community facilities. Several projects, which were sponsored by regional or State development authorities, modernized obsolete facilities for value-added agricultural products, or created new facilities to promote local economic growth. These projects were designed to promote economic growth in rural areas by attracting and promoting businesses that create or retain jobs in these rural communities.

Non-System financial institutions and venture capital funds have also benefited from investments that System institutions made under the pilot programs. For example, System institutions have helped to increase liquidity at several rural community banks by buying bonds that support the rural development efforts of these banks. These investments enabled these banks to reduce the long-term financing costs for specific rural development projects. Additionally, investments in regional investment networks provided venture capital to rural entrepreneurs for start-up businesses that contributed to the vitality of rural communities. System institutions were prudent in undertaking investment activities in rural communities and assumed reasonable risks within pilot program conditions.

In addition to the pilot programs, grant programs and charitable contributions at many System institutions complement their commitments to the citizens of local rural communities. Although the proposed rule does not specifically address grants, System institutions have authority under the incidental power provisions of the Act to make charitable grants and donations.[13] The FCA continues to encourage FCS institutions to consider making charitable donations and contributions to worthwhile causes in the communities they serve. System institutions have contributed to a wide variety of community organizations and entities, including emergency and medical services, agricultural and rural community development educational programs, and value-added agricultural product initiatives. Charitable grants by System institutions complement rural community investment programs and are an additional way for Farm Credit institutions to further the System's mission and help enhance the quality of life for residents in rural communities.

II. <u>Section-by-Section Analysis</u>

A. <u>Rural Communities</u>

Proposed § 615.5176(a) would authorize Farm Credit banks, associations, and service corporations to make rural community investments. Proposed § 615.5176(a) also provides that FCS institutions may make these investments only in areas <u>outside</u> of an "urbanized area"[14] as defined by the latest decennial census of the United States. For the purposes of this proposed rule, areas outside of an urbanized area are "rural." The proposed rule would authorize the FCS to make rural community investments in areas that the United States Census Bureau determined in the latest decennial census to have a population of less than 50,000 residents. For the purposes under this proposed rule, the geographic area includes any State within the United States and the Commonwealth of Puerto Rico.

The FCA considered numerous definitions of "rural," recognizing there is no single, universally

preferred definition of "rural" that policymakers commonly use.[15] In fact, more than 15 definitions of "rural" are currently used by different Federal agencies for various programs.[16] In developing the proposed rule, the FCA relied on Census Bureau terminology to ensure that the geographic areas in which investments are permitted are readily identifiable and easily distinguished.

In determining which geographic areas should qualify under the proposed rule, the FCA seeks to include those areas with sufficient population densities to support health care and other essential facilities serving rural residents, while prohibiting investments in urbanized areas. For example, hospitals and other health care facilities that primarily serve rural geographic areas are typically located in areas that have less than 50,000 residents. Also, whenever Congress has expressly authorized FCS institutions to lend or invest in rural development projects, it has allowed these activities in communities with populations of 50,000 or fewer residents.[17] Additionally, most Federal agencies and demographic experts have determined that densely populated areas with 50,000 or more inhabitants are urbanized areas. For this reason, investments authorized under the proposed rule would allow System institutions to invest in areas with populations of less than 50,000 residents based on the latest decennial census of the United States.

By allowing the System to invest in rural communities that have fewer than 50,000 residents, the proposed rule provides "an adequate and flexible flow of funds into rural areas" in accordance with the Act, while precluding System institutions from investing in urbanized areas. Information is publicly available on the Census Bureau's Web site, including census population statistics and maps. As a result, System institutions and other interested parties are able to determine if a particular location is within a "rural" community for the purposes of § 615.5176(a).

B. Debt Securities

Proposed § 615.5176(b) would authorize System institutions to invest in rural communities by purchasing and holding debt securities for purposes specified in § 615.5176(b)(1) through (5). The proposed rule defines debt securities as obligations that are commonly recognized in capital markets as a medium for investment, including government obligations, corporate bonds, revenue bonds, asset-backed securities and mortgage securities. Proposed § 615.5176(b) expressly excludes commercial loans and instruments or transactions that are more similar to commercial loans than to traditional investment instruments in order to clarify the statutory distinction between loans and investments. Under the proposed rule, System institutions could not use their authority to invest in rural communities to make loans to otherwise ineligible borrowers.

1. Essential Community Facilities

Proposed § 615.5176(b)(1) would authorize System institutions to invest in debt securities that finance essential community facilities, such as hospitals, health care facilities, emergency services, and schools. Many essential community facilities are owned and operated by State, local, or municipal governments. In other cases, quasi-governmental or highly regulated private and nonprofit entities own and operate essential community facilities. Government obligations and revenue bonds often fund the construction and renovation of these facilities. Rural communities are currently facing increasing difficulty in funding these facilities because of deteriorating liquidity in financial markets. System institutions can help alleviate this problem by purchasing and holding debt securities as investments in community facilities that provide essential services to rural residents.

2. Basic Transportation Infrastructure

Financing basic transportation infrastructure, such as roads, bridges, and other public

transportation systems, is another authorized investment purpose under the proposed rule. The public sector owns, maintains, and operates most basic transportation infrastructure in the United States. Most rural transportation facilities are operated by public agencies or nonprofit groups, with a small percentage operated by private entities. Transportation projects are another area where the System could significantly help rural communities build and improve infrastructure, which would strengthen their economic viability. Rural communities and particularly agricultural industries, depend on quality transportation systems, which are critical in supplying inputs, shipping and distributing outputs and products, and supporting economic development. Proposed § 615.5176(b)(2) would authorize System institutions to purchase government obligations, revenue bonds, and other debt obligations that support basic transportation infrastructure.

3. Revitalization of Rural Communities After a Disaster

Proposed § 615.5176(b)(3) would permit System institutions to purchase debt securities in revitalization projects that help rebuild rural areas devastated by disasters where an emergency has been declared pursuant to law. These investments must support local efforts and residents by contributing to the economic recovery of the affected rural community.

4. Rural Development Projects with Government Sponsorship or Guarantees

Under proposed § 615.5176(b)(4), System institutions could invest in debt securities that a government issues, sponsors, or guarantees under programs to fund rural community development projects. Without crucial financial support from Federal, State, or local governments, rural communities would face greater difficulty in funding vital development projects. By investing in debt securities for rural economic development under government programs, the System assists rural communities across America in accordance with its statutory mandate. By proposing § 615.5176(b)(4), the FCA is encouraging System institutions to work with Federal, State, and local governments and their partners to invest in projects that bring jobs, infrastructure, community facilities, and vital services to rural areas and their residents.

Proposed § 615.5176(b)(4)(i) covers debt securities that the United States and its agencies issue, sponsor, or guarantee under programs that have the specific purpose of directly financing economic development in rural communities. The FCA emphasizes that the proposed rule does not require the full faith and credit of the United States for bonds issued or guaranteed by agencies of the United States. However, these investments are authorized only if the Federal agency issues or guarantees these bonds or obligations in accordance with a program that has the specific purpose of promoting economic development in rural areas. For example, the Tennessee Valley Authority, the Small Business Administration, and various agencies in the USDA and the Department of Housing and Urban Development issue and guarantee bonds under specific programs for infrastructure, facilities, and other development projects in rural areas, and System investment in these obligations would be authorized by the proposed rule.

Other Federal agencies operate programs in both metropolitan and rural areas which are not part of any specific rural development mission. Bonds and other obligations issued or guaranteed under such programs would not qualify as investments under the proposed rule. For example, the proposed rule would not authorize the FCS to invest in mortgage securities issued or guaranteed by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation because the purpose of these securities is to enhance the liquidity of residential home loans throughout the United States, rather than to promote rural development. Another regulation, § 615.5140, permits System institutions to make investments for liquidity and risk-management purposes in bonds and obligations, including residential

mortgage securities, that Federal agencies issue or guarantee under programs that are unrelated to rural development. The proposed rule focuses on investments in rural communities and would not authorize System institutions to hold residential mortgage securities issued by other GSEs, but the FCA continues to study this issue.

Proposed § 615.5176(b)(4)(ii) would allow System institutions to invest in debt securities that any State, the Commonwealth of Puerto Rico, a local or municipal government, or other political subdivision of a State, issues, sponsors, or guarantees that are specifically related to development in rural communities. Many local or municipal governments and other political subdivisions, such as special districts, often sponsor particular rural development projects by providing tax incentives or other benefits to private-sector obligors who issue revenue bonds. These revenue bonds, which help finance rural development projects, would qualify as investments that FCS institutions could purchase and hold under proposed § 615.5176(b)(4)(ii). This provision would also allow System institutions to invest in mortgage securities that are issued or guaranteed by State or local agencies that specialize in rural development.

5. Rural Development Projects Financed by Non-System Financial Institutions

Proposed § 615.5176(b)(5) would allow System institutions to invest in debt securities issued by non-System financial institutions. The proposed rule would authorize System institutions to purchase these debt securities to increase financial assistance to rural communities and improve the liquidity of rural financial markets. This provision would enhance cooperation between System and non-System financial institutions and ultimately benefit rural communities. System institutions may purchase asset-backed securities, covered bonds, or similar types of bonds issued by non-System financial institutions directly or through trusts that supply funds to non-System financial institutions for rural development. Investments made under the pilot programs evidence that securities, including commercial bank bonds issued by rural community banks and purchased by System institutions, can effectively increase bank liquidity. These investments benefit rural communities and residents, while establishing partnerships between non-System and System institutions.

C. Equity Investments

Equity investments in venture capital funds are another type of investment that the proposed rule would authorize FCS institutions to purchase and hold. Under this provision of the proposed rule, System institutions could invest in venture capital funds that provide capital to start-up and small private-sector enterprises that bring jobs and economic opportunities to rural communities. Venture capital funds that operate in the United States invest only 1.6 percent of their funds in rural community enterprises, although these enterprises represent 19.2 percent of all businesses.[18] System institutions could make a small, but meaningful, contribution to rural economic development by investing in venture capital funds that provide capital into rural enterprises. As discussed in greater detail below, System institutions would hold only small, passive investment positions in venture capital funds because of statutory and regulatory restrictions.

Proposed § 615.5176(c) would authorize System institutions to make equity investments in two types of entities, RBICs and venture capital funds, for the purpose of providing equity capital to rural business enterprises. Rural entrepreneurs often lack sufficient equity capital to establish and expand businesses that are the mainstay of prosperous rural economies. Venture capital funds provide equity capital in rural business enterprises, which promote economic development and job opportunities in rural communities.

1. Rural Business Investment Companies

Proposed § 615.5176(c)(1) would authorize System institutions to purchase and hold equity investments in RBICs that are established and operate in accordance with 7 U.S.C. 2009cc et seq. As discussed earlier, the Farm Security and Rural Investment Act of 2002 created the Rural Business Investment Program and expressly authorized any Farm Credit System institution to establish and invest in RBICs. Congress intended to promote economic development, create wealth, and expand job opportunities in rural areas through RBIC equity investments. The System's statutory authority to establish and invest in RBICs is incorporated into proposed § 615.5176(c)(1). The proposed rule would enable System institutions to invest in RBICs to the fullest extent allowed by 7 U.S.C. 2009cc et seq. The FCA emphasizes that proposed § 615.5176(c)(1) would authorize System institutions to invest in both leveraged and non-leveraged RBICs.

2. Venture Capital Funds

Proposed § 615.5176(c)(2) would authorize System institutions to invest in venture capital funds which, in turn, invest in rural businesses that provide job opportunities. Under this provision, System institutions would be able to indirectly provide rural entrepreneurs needed equity capital through venture capital funds, such as regional investor networks, which have investment objectives similar to RBICs.

The Center for the Study of Rural America of the Federal Reserve Bank of Kansas identified a significant need for equity capital for rural entrepreneurs because entrepreneurial activity is strongly linked to economic growth.[19] For this reason, experts conclude that additional focus on rural entrepreneurship can be an effective strategy in combating the decline of traditional resource-based businesses in rural areas.[20] However, rural economies have difficulty attracting venture capital because metropolitan areas usually offer better profits. Policy officials and experts agree that entrepreneurship in remote and sparsely populated rural areas can be challenging because access to skilled labor, technology, and capital is more limited. Investments in venture capital funds that focus on rural entrepreneurs can effectively begin to overcome these barriers to rural businesses.

Proposed § 615.5176(c)(2) would place specific restrictions on System investment in venture capital funds to ensure that these investments remain small and passive. Additionally, these controls would minimize potential financial risk to the System institutions, while providing the System with flexibility to invest in rural development under the Act.

Proposed § 615.5176(c)(2)(i) would control financial risk by prohibiting any System institution from investing more than 5 percent of its total surplus in venture capital funds and more than 2 percent of its total surplus in any one venture capital fund. The FCA emphasizes that this limit on venture capital funds in proposed § 615.5176(c)(2)(i) is in addition to the overall limit in proposed § 615.5176(e)(i), which prevents total rural community investments at any FCS institution from exceeding 150 percent of its total surplus.

The restrictions in proposed § 615.5176(c)(2)(ii) and (iii) would prevent System institutions from controlling and managing venture capital funds. Proposed § 615.5176(c)(2)(ii) would prohibit any FCS institution from holding more than 20 percent of the voting equity of any venture capital fund. The purpose of this provision is to allow System institutions to invest in venture capital funds that focus on rural areas, while imposing a reasonable limit that prevents any System institution from gaining a controlling interest in any fund. Proposed § 615.5176(c)(2)(iii) would prohibit any FCS institution from participating in the routine management or operation of a venture capital fund.

Finally, proposed § 615.5176(c)(2)(iv) and (v) would establish controls to avoid potential

conflicts of interest. Proposed § 615.5176(c)(2)(iv) would prohibit any director, officer, or employee of a System institution from serving as a director, officer, employee, principal shareholder, or trustee of any venture capital fund or of any entity funded by, or affiliated with, the venture capital fund. Proposed § 615.5176(c)(2)(v) would prohibit any System institution from participating in any decision or action of a venture capital fund involving or affecting any customer of the institution. Although proposed § 615.5176(c)(2)(v) would permit a System institution to invest in venture capital funds that hold equity in one of its borrowers, the institution could not participate in decisions or actions that affect such customers. Additionally, the proposed rule does not prohibit System institution directors, officers, or employees from serving in an investment screening or other advisory capacity to a venture capital fund, subject to the restrictions discussed above. System institution representatives serving in an advisory capacity to a venture capital fund also remain subject to FCA conflict of interest regulations and institution policies.

D. Other Investments Approved by the Farm Credit Administration

The FCA's experience with the pilot programs reveals that the types of System investments may change as the needs of rural communities evolve. For this reason, the FCA believes that the new regulation should contain a mechanism for approving investments that currently do not exist, but may emerge in the future. Currently, § 615.5140(e) provides the FCA with the authority to approve new investments that are not specifically authorized by regulation.

Proposed § 615.5176(d) establishes specific criteria for System institutions to apply to the FCA for permission to hold investments that are not expressly authorized by this regulation. Under this proposal, written requests by System institutions would: (1) Describe the proposed project or program in detail; (2) explain its risk characteristics; and (3) demonstrate how such investments are consistent with the System's statutory mandate to serve agriculture and rural communities. In approving such requests, the FCA may impose additional or more stringent conditions than the requirements of this regulation to ensure safety and soundness or compliance with law.

E. Restrictions on Rural Community Investments

Other requirements governing System investments in rural communities are covered by proposed § 615.5176(e). These requirements either pertain to safety and soundness or implement statutory requirements.

1. Portfolio Limit

Proposed § 615.5176(e)(1) would authorize each System bank, association, or service corporation to make rural community investments in an amount not to exceed 150 percent of the institution’s total surplus. The proposed portfolio limit on rural community investments ensures that lending to farmers, ranchers, aquatic producers, cooperatives, and other borrowers that own the FCS remains the primary activity of System institutions. At the same time, the proposed limit provides the FCS with the flexibility to make investments in an amount that offers meaningful assistance to rural communities and their residents. This limit on rural community investments is compatible with limits that the Act and other FCA regulations impose on System activities that are related to the System’s mission.

Based on financial information reported as of December 31, 2007, the proposed limit would authorize the System to invest up to a total of $35.8 billion in rural community investments.[21] For example, this would permit an FCS association with $1.0 billion in assets and $150.0 million in total surplus to invest up to $225.0 million in rural communities.

The FCA considered the following factors when it decided to propose 150 percent of total surplus as the portfolio limit: (1) The safety and soundness of FCS institutions; (2) the significant needs of rural communities; (3) the FCS's ability and capacity to assist rural communities, and (4) the ability of FCS institutions to fulfill mission objectives. Total surplus provides a basis for each institution's risk tolerance level, and the FCA has historically used this standard to limit System investments in unrated obligations that are less liquid. System institutions also use limits based on similar capital measures to ensure that asset and portfolio concentrations are safely and soundly managed.

This proposed limit also is based on the limits established for the pilot programs. The FCA established individual institution limits equal to 100 percent of total surplus (or in some cases 10 percent of total loans) for investments held under specific pilot programs, and 150 percent of total surplus for an institution's portfolio of all rural community investments. The pilot programs evidence that System institutions exercised caution when making investments in rural communities. Institutions have not approached the portfolio limit. Although the proposed rule establishes an upper regulatory portfolio limit, the FCA expects that each System institution would determine an appropriate internal portfolio limit based on the individual institution's objectives, capital position, risk tolerance, and other factors that it considers appropriate, in accordance with § 615.5133(c).

The FCA also considered the System's need to establish a program of sufficient size that could adequately deliver benefits to rural communities while balancing operational efficiency needs. In establishing the portfolio limit, the FCA sought to ensure that each System institution, large or small, could effectively partner with government agencies and non-System financial institutions in projects that may positively affect their local rural communities.

The current credit crisis emphasizes the importance of funding for rural development projects and enhancing the liquidity of rural credit markets. The portfolio limit curtails the maximum risk exposure of System institutions, and it also encourages partnerships with non-System financial institutions and government agencies that are active in rural development. Collaboration between System institutions and larger, more established financial investors is a way to help rural communities access financing for vital projects, especially during times of economic uncertainty.

2. Obligor Limit

Proposed § 615.5176(e)(2) would establish an obligor limit for investments in rural communities. This provision would not allow any System institution to invest more than 15 percent of its total surplus in investments issued by a single entity, issuer, or obligor. However, the obligor limit would not apply to obligations issued or guaranteed on the full faith and credit of the United States, its agencies, instrumentalities, or corporations. In the event only a portion of the obligation is guaranteed, the non-guaranteed portion of the obligation would remain subject to the obligor limit.

This obligor limit is designed to control undue credit risk from a single counterparty on the capital of any System institution and provide sufficient diversification of an institution's rural community investment portfolio. For safety and soundness reasons, the FCA decided that the obligor limit for rural community investments should be lower than the 20 percent of total capital obligor limit established for investments held by System institutions to maintain liquidity and manage market risks in § 615.5140(d). In contrast to the liquid and marketable securities held under § 615.5140, rural community investments are often unrated and, therefore, capital markets would consider them less liquid. The FCA anticipates that most rural community investments would be held to maturity and would not trade. For these reasons, the FCA proposes an obligor limit for rural community investments that does not exceed 15 percent of the

total surplus of each System institution.

This regulatory provision would also require a System institution to count securities that it holds through an investment company towards this 15-percent obligor limit to prevent undue risk concentrations. This provision provides an exception when the investment company's holding of the security of any one issuer does not exceed 5 percent of the investment company's total portfolio. The FCA patterned this provision after § 615.5140(d)(2), which applies to investments that FCS institutions hold through investment companies for the purposes of maintaining liquidity or managing market risks.

The FCA emphasizes that proposed § 615.5176(e)(2) establishes a maximum obligor limit for rural community investments. The FCA expects every Farm Credit institution to establish internal obligor limits based on its financial condition and the size and complexity of securities that it contemplates buying and holding. The obligor limit that each System institution sets should be based on both identified risks and its own risk-bearing capacity.

3. Maturities for Debt Securities in Rural Communities

Proposed § 615.5176(e)(3) would require most rural community investments to mature in no more than 20 years. However, debt securities may mature in not more than 40 years if the United States or its agencies provide a guarantee or a conditional commitment of guarantee for 50 percent or more of the total issuance or obligation. Proposed § 615.5176(e)(3) establishes terms to maturity that are flexible enough to accommodate typical rural development projects that this rule would authorize. This regulatory approach would enable System institutions to participate in USDA and other State rural development programs that provide a supplemental or partial guarantee, which contributes to, or enhances, whole-project financing. Also, investments that fund essential rural community facilities, such as hospitals, police and fire stations, and other emergency service facilities, typically require project financing over longer terms to maturity.

4. Exclusion from the Liquidity Reserve

Proposed § 615.5176(e)(4) would require System banks to exclude rural community investments from their liquidity reserve under § 615.5134 of this part. System banks may purchase and hold the eligible investments listed in
§ 615.5140 to maintain liquidity reserves, manage interest rate risk, and invest surplus short-term funds in accordance with § 615.5132. Only investments that can be promptly converted into cash without significant loss are suitable for achieving these objectives. Rural community investments are not suitable for liquidity purposes or market risk management because these investments do not typically carry ratings assigned by a Nationally Recognized Statistical Rating Organization and are not actively traded in the established secondary markets.

5. Association Investments

Proposed § 615.5176(e)(5) would implement sections 2.2(10) and 2.12(18)[22] of the Act, which require each funding bank to supervise and approve the investment activities of its affiliated associations. System banks may discharge their statutory and regulatory responsibility to approve and supervise an association's rural community investments through covenants in the general financing agreement, policies, or other appropriate formats. System banks may also provide advisory, analytical, and research services that help their affiliated associations to devise strategies for investing in rural communities and managing these assets.

6. Attribution of Service Corporation Investments

Proposed § 615.5176(e)(6) would require System service corporations to attribute all rural community investments to their System institution parents based on the ownership percentage of each bank or association. This provision would prevent FCS institutions from utilizing service corporations to exceed the regulatory limits on rural community investments.

F. Management of Rural Community Investments

Proposed § 615.5176(f) addresses rural community investment management practices at FCS institutions and ensures that System institutions invest in rural communities in a safe and sound manner. If a Farm Credit System institution chooses to invest in rural communities, proposed § 615.5176(f) would require its board of directors to first adopt written policies for managing the institution's investments. These investment management policies must be appropriate for the levels, types, and complexities of each institution's rural community investments. Proposed § 615.5176(f) would also require the board of directors ensure the institution's implementation of procedures and internal controls that ensure compliance with the board's policies and the regulation.

Additionally, proposed § 615.5176(f) would require these written policies to comply with § 615.5133, which governs management practices for investments held for liquidity and risk management. Although rural community investments differ from liquid investments, strong and disciplined investment management practices are essential to the safety and soundness of all investment activities within System institutions. As a result, sound investment management practices prescribed by § 615.5133 are also applicable to rural community investments and, for this reason, the FCA is extending § 615.5133 to rural community investments.

Existing § 615.5133 requires a System institution's investment management policies to address risk tolerance, delegations of authority, internal controls, securities valuation, and reporting to the board. Also, § 615.5133 requires that investment policies be appropriate for the size, type, and risk characteristics of the institution's investments. The FCA expects each System institution to fully and carefully evaluate its risk tolerance in accordance with § 615.5133(c) when it considers purchasing any rural community investments. Finally, proposed § 615.5176(f) expressly exempts those rural community investments that System institutions classify and account for as held-to-maturity under generally accepted accounting principles from the securities valuation requirement in § 615.5133(f). This exemption is based on the different accounting classifications for these securities.

G. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FCA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that qualify them as small entities. Therefore, System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

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[1] 12 U.S.C. 2013(15) and 2122(13)(A).

[2] 12 U.S.C. 2073(10) and 2093(18).

[3]12 U.S.C. 2211. Section 4.25 authorizes System banks to organize service corporations. Section 4.28A of the Act, 12 U.S.C. 2214a, confers this authority on System associations.

[4]Section 4.25 of the Act prohibits service corporations from extending credit or providing insurance services to System borrowers. Otherwise, the Act authorizes service corporations to perform any other function or service that its FCS parents may perform. Service corporations currently have authority to purchase and hold other investments under FCA regulations in subpart E of part 615.

[5]Pub. L. No. 107-171, § 384J, 116 Stat. 134, 397 (May 13, 2002).

[6]The farmers' note program authorizes production credit associations and agricultural credit associations to invest in notes, contracts, and other obligations farmers and ranchers enter into with cooperatives and dealers that sell farm equipment, inputs, and supplies. Farmers' notes are investments that provide liquidity to small rural agribusinesses.

[7]Carol A. Jones, et al., "Population Dynamics Are Changing the Profile of Rural Areas," Amber Waves, Economic Research Service, United States Department of Agriculture, April 2007, p. 5.

[8]"Rural Education At A Glance," Rural Development Research Report Number 98, Economic Research Service, United States Department of Agriculture, November 2003, p. 4.

[9]Walter Gregg, The Availability and Use of Capital by Critical Access Hospitals, Flex Monitoring Team Briefing Paper No. 4, Flex Monitoring Team – University of Minnesota, University of North Carolina at Chapel Hill, and the University of Southern Maine, March 2005, p. 10.

[10]Ibid., p. 25 and 26.

[11]Ted Covey, et al., "Agricultural Income and Finance Outlook," Outlook, AIS-85, Economic Research Service, United States Department of Agriculture, December 2007, p. 49.

[12] "Chapter 3-Focus on Agriculture," Worker Health Chartbook 2004, National Institute for Occupational Safety and Health, NIOSH Publication No. 2004-146, p. 1.

[13]Sections 1.5(21), 2.2(20), 2.12(20) and 3.1(16) of the Farm Credit Act (12 U.S.C. 2013(21), 2073(20), 2093(20), 2122(16)).

[14]The United States Census Bureau defines an urbanized area as an urban area of 50,000 or more people that have core census block groups or blocks that have a population density of at least 1,000 people per square mile and surrounding census blocks that have an overall density of at least 500 people per square mile.

[15]Andrew F. Coburn et al., "Choosing Rural Definitions: Implications for Health Policy," Rural Policy Research Institute Health Panel, March 2007, p. 1.

[16]Ibid.

[17]According to section 3.7(f) of the Act, 12 U.S.C. 2128(f), banks for cooperatives and agricultural credit

banks may extend credit to water and waste disposal facilities in communities where the population does not exceed 20,000 inhabitants based on the latest decennial census of the United States. A provision of the Farm Security and Rural Investment Act of 2002, 7 U.S.C. 2009cc, et seq., authorizes System institutions to establish and invest in rural business investment companies in communities in non-metropolitan counties that have populations of 50,000 or less inhabitants under the last decennial census of the Unites States.

[18]Kendall McDaniel, "Venturing into Rural America," The Main Street Economist, Center for the Study of Rural America – Federal Reserve Bank of Kansas City, p. 2.

[19]Mark Drabenstott, et al., "Main Streets of Tomorrow: Growing and Financing Rural Entrepreneurs - A Conference Summary," Economic Review, Third Quarter 2003, Federal Reserve Bank of Kansas City, p. 73 and 74.

[20]Ibid.

[21]This amount is comparable to the regulatory limits established for the System's rural home lending and investments in farmers' notes activities, which are limited to amounts totaling $35.9 billion for each program as of year-end, although actual amounts outstanding under these programs represented 1.3 percent and less than 1 percent of total outstanding loans, respectively.

[22]12 U.S.C. 2073(10) and 2093(18).

List of Subjects in 12 CFR Part 615

Accounting, Agriculture, Banks, banking, Government securities, Investments, Rural areas.

For the reasons stated in the preamble, part 615 of chapter VI, title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 615--FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS, AND FUNDING OPERATIONS

1. The authority citation for part 615 is revised to read as follows:

Authority: Secs. 1.1, 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.3, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2001, 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b-6, 2279aa, 2279aa-3, 2279aa-4, 2279aa-6, 2279aa-7, 2279aa-8, 2279aa-10, 2279aa-12); 7 U.S.C 2009cc et seq.; sec. 301(a) of Pub. L. 100-233, 101 Stat. 1568, 1608.

Subpart F--Property, Transfers of Capital and Other Investments

2. A new § 615.5176 is added to subpart F to read as follows:

§ 615.5176 Rural community investments.

(a) *Rural communities.* As authorized by this section, each Farm Credit System (System) bank, association, or service corporation (hereafter "institution") may make rural community investments. All investments that any System institution makes under this section in rural communities must be outside an urbanized area as determined by the latest decennial census of the United States.

(b) *Debt securities.* Each institution may make investments in rural communities by purchasing and holding debt securities. For the purposes of this section, debt securities are obligations that are commonly recognized in the established capital markets as a medium for investment. Debt securities exclude commercial loans and any instrument or transaction that is more similar to a commercial loan than to a traditional investment instrument or transaction. Debt securities include government obligations, corporate debt obligations, revenue bonds, asset-backed securities, as defined by § 615.5131(a), and mortgage securities, as defined by § 615.5131(h). Debt securities that institutions purchase and hold under this section must provide funding in rural communities for:

(1) Essential community facilities such as hospitals, clinics, emergency services, and schools;

(2) Basic transportation infrastructure, such as roads, bridges, and other public transportation systems;

(3) Revitalization projects that rebuild rural areas recovering from disasters where an emergency has been declared pursuant to law;

(4) Rural development projects for which the issuer, sponsor, or provider of a guarantee is:

(i) The United States or any of its agencies, instrumentalities, or corporations, under programs that have the specific purpose of directly financing economic development in rural areas; or

(ii) Any State, the Commonwealth of Puerto Rico, local or municipal governments, or other political subdivisions.

(5) Non-System financial institutions for their activities that support rural development.

(c) *Equity investments.* System institutions may also make investments in:

(1) *Rural Business Investment Companies* that are established and operate in accordance with 7

U.S.C. 2009cc et seq.; or

(2) Venture capital funds that are established to promote economic development and job opportunities in businesses located in rural communities, so long as an institution does not:

(i) Invest more than 5 percent of its total surplus in venture capital funds and more than 2 percent of its total surplus in any one venture capital fund;

(ii) Hold more than 20 percent of the voting equity of any one venture capital fund;

(iii) Participate in the routine management or operation of any venture capital fund;

(iv) Allow any institution director, officer, or employee to serve as director, officer, employee, principal shareholder, or trustee of any venture capital fund, or of any entity funded by, or affiliated with any venture capital fund; or

(v) Participate in any decision or action of any venture capital fund involving or affecting any customer of the institution.

(d) Other investments approved by the Farm Credit Administration. System institutions may make other investments in rural communities that are not expressly authorized by this section if they are approved by the Farm Credit Administration. Written requests for Farm Credit Administration approval must describe the proposed project or program in detail, explain its risk characteristics, and demonstrate how such investments are consistent with the statutory mandate of the Farm Credit System.

(e) Restrictions on rural community investments.

(1) Portfolio limit. An institution must not invest more than 150 percent of its total surplus in rural community investments.

(2) Obligor limit. An institution must not invest more than 15 percent of its total surplus in rural community investments issued by any single entity, issuer, or obligor. This obligor limit does not apply to obligations of the United States or its agencies, instrumentalities, or corporations. An institution must count securities that it holds through an investment company towards the obligor limit of this section unless the investment company's holding of the securities of any one issuer does not exceed 5 percent of the investment company's total portfolio.

(3) Maturities for debt securities. Debt securities purchased by institutions under this section must mature in not more than 20 years, except that debt securities may mature in not more than 40 years if the United States or its agencies provide a guarantee or a conditional commitment of guarantee for 50 percent or more of the total issuance or obligation.

(4) Exclusion from the liquidity reserve. No Farm Credit bank shall include any investment made in accordance with this section in its liquidity reserve under § 615.5134 of this part.

(5) Association investments. A System association may hold rural community investments only with the approval of its funding bank. Each district Farm Credit bank must annually review all rural community investments held by its affiliated associations.

(6) Attribution of service corporation investments. All investments in rural communities that service corporations hold under this section must be attributed to their System institution parents based on the ownership percentage of each bank or association.

(f) Management of rural community investments. Before a System institution invests in rural communities, its board of directors must first adopt written policies for managing the institution's rural community investments. Investment management policies must be appropriate for the levels, types, and complexities of each institution's rural community investments. These written policies must comply with requirements of § 615.5133. Investments made under this section that System institutions classify and account for as held-to-maturity securities in accordance with generally accepted accounting principles are exempt from the requirements of paragraph (f) of § 615.5133. The board of directors must ensure that the institution implements procedures and internal controls to ensure compliance with the board's policies and the regulation.

Dated: June 10, 2008

Roland Smith,
Secretary,
Farm Credit Administration Board.

76 FR 80817, 12/27/2011

Handbook Mailing HM-11-14

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AC54

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Liquidity and Funding

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, we or us) proposes to amend its liquidity regulation. The purpose of the proposed rule is to strengthen liquidity risk management at Farm Credit System (FCS or System) banks, improve the quality of assets in the liquidity reserve, and bolster the ability of System banks to fund their obligations and continue their operations during times of economic, financial, or market adversity.

DATES: Comments should be received on or before February 27, 2012.

ADDRESSES: We offer a variety of methods for you to submit your comments. For accuracy and efficiency, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Comments" and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of comments we receive at our office in McLean, Virginia, or from our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

David J. Lewandrowski, Senior Policy Analyst, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA, (703) 883-4498, TTY (703) 883-4434;

or

Richard A. Katz, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of the proposed rule are to:

- Improve the capacity of FCS banks to pay their obligations and fund their operations by maintaining adequate liquidity to withstand various market disruptions and adverse financial or economic conditions;
- Strengthen liquidity management at all FCS banks;
- Enhance the marketability of assets that System banks hold in their liquidity reserve;
- Require that cash and highly liquid investments comprise the first 30 days of the 90-day liquidity reserve;
- Establish a supplemental liquidity buffer that a bank can draw upon during an emergency and that is sufficient to cover the bank's liquidity needs beyond the 90-day liquidity reserve; and
- Strengthen each bank's Contingency Funding Plan (CFP).

II. Background

The FCS is a nationwide network of borrower-owned financial cooperatives that lend to farmers, ranchers, aquatic producers and harvesters, agricultural cooperatives, rural utilities, farm-related service businesses, and rural homeowners. By law, FCS institutions are instrumentalities of the United States,[1] and Government-sponsored enterprises (GSEs).[2] According to section 1.1(a) of the Farm Credit Act of 1971, as amended, (Act), Congress established the System for the purpose of furnishing "sound, adequate, and constructive credit and closely related services" to farmers, ranchers, aquatic producers and harvesters, their cooperatives, and certain farm-related businesses necessary to fund efficient agricultural operations in the United States.

In many respects, the FCS is different from other lenders. In contrast to commercial banks and most other financial institutions, the System lends mostly to agriculture and in rural areas. Unlike most other lenders, FCS banks and associations are cooperatives that are owned and controlled by their agricultural borrowers, and their common equity is not publicly traded.

The System funds its operations differently than most commercial lenders. FCS banks issue System-wide debt securities, which are the System's primary source for funding loans to agricultural producers, their cooperatives, and other eligible borrowers.[3] Although section 4.2(a) of the Act authorizes FCS banks to borrow from commercial banks and other lending institutions, lines of credit with non-System lenders are a negligible source of FCS funding. FCS banks and associations are not

depository institutions.

The System's ability to finance agriculture, rural housing, and rural utilities in both good and bad economic times primarily depends on continuing access to the debt markets. During normal economic conditions, access to debt markets provides the System with funds it needs to operate. However, if access to the debt markets becomes impeded for any reason, Farm Credit banks must rely on assets to continue operations and pay maturing obligations. Liquidity is the ability to convert assets into cash quickly and at a price that is close to their book value.

In contrast to commercial banks, savings associations, and credit unions, the FCS does not have guaranteed access to a government provider of liquidity in an emergency.[4] If market access is impeded, FCS banks must rely on their liquidity reserves more heavily than other federally regulated lending institutions[5] because they do not have a assured lender of last resort.[6]

The liquidity of System banks has drawn more scrutiny from the FCA, credit rating agencies, and investors as economic and financial turmoil have roiled the markets with greater frequency and magnitude in recent years. As a result, the FCA proposes to amend its liquidity regulations so that FCS banks are better able to withstand uncertainty and instability in the financial markets.[7]

Liquidity is important for the financial system as a whole. Recent market disruptions have raised concerns among regulators, credit rating agencies, investors, and other market participants about the ability of financial institutions to maintain sufficient liquidity to meet their immediate funding needs during times of economic and financial turmoil.[8] The experience of these crises demonstrates why sound liquidity risk management is important to the safety and soundness of individual financial institutions and the financial system as a whole.

Regulatory agencies, in particular, have responded by formulating more comprehensive supervisory approaches toward liquidity risk management at financial institutions. For example, the Basel Committee on Banking Supervision (Basel Committee) issued in September 2008, the Principles for Sound Liquidity Risk Management and Supervision, which contains 17 principles detailing international supervisory guidance for sound liquidity risk management. In December, 2010, the Basel Committee issued Basel III: International framework for liquidity risk measurement, standards, and monitoring (Basel III Liquidity Framework). On March 22, 2010, the five Federal agencies that regulate depository institutions (Federal banking agencies)[9] published their Interagency Policy Statement on Funding and Liquidity Risk Management[10], which sets forth the supervisory expectations for depository institutions. The purpose of all these documents is to guide the supervisory efforts of Federal and international regulators of depository institutions into the future.

The FCA has considered the guidance of both the Basel Committee and the Federal banking agencies as part of its efforts to develop revised liquidity regulations. Many of the core concepts that the Basel Committee and the Federal banking agencies articulated about liquidity are appropriate for our proposed rule. However, the corporate, funding, and lending structures of the FCS are fundamentally different from those of depository institutions and, therefore, the FCA has modified and adapted the guidance of international regulators and Federal banking agencies concerning liquidity risk management so they are relevant to the System's unique circumstances, needs, and structure. The FCA also added other requirements that are tailored to the System's unique nature.

In addition to the guidance of the Basel Committee and other Federal regulators, both the FCA and the System have implemented various measures to improve liquidity management so FCS banks are in a better position to withstand financial and economic shocks. More specifically, System banks agreed

to a common framework that stipulated the days of liquidity coverage that they would maintain, and established the parameter for the quality of investments held in their liquidity reserves.

The FCA also took action to improve the ability of FCS banks to maintain sufficient liquidity to outlast episodes of market turbulence. On November 13, 2008, the FCA Board passed a Market Emergency Standby Resolution that waives the 90-day liquidity reserve requirement in § 615.5134 for a limited period of time if a crisis shuts, or severely restricts access to, debt markets. On May 5, 2009, the FCA issued a letter to FCS banks and the Funding Corporation that required the standing monthly collateral certification of all banks to include detailed information about days of liquidity in a specified format. This directive also required reporting of days of liquidity for each FCS bank and the FCS in aggregate, and detailed information about the type and remaining term of the investments from which those days of liquidity are derived.

FCS banks withstood recent economic and financial turmoil with their liquidity intact. Both the FCA and FCS have gained valuable experience and insights into the effects that sudden and severe stress have on liquidity at individual FCS institutions and the financial system as a whole. The FCA has identified several vulnerabilities that need to be addressed:

(1) Banks must ensure that the liquidity reserve is managed primarily as an emergency source of funding;

(2) Board policies need to provide clearer guidance to the asset-liability committee (ALCO) for monitoring, measuring, and managing liquidity risk;

(3) Risk analyses need to address how investments that the bank purchases and hold actually achieve its primary liquidity objective.

(4) Contingency funding plans need to provide orderly and effective procedures that would allow the bank to maintain sufficient liquidity to fund its operations during each phase of an emerging crisis;

(5) Discounts that FCS banks apply to the market values of assets in the liquidity reserve pursuant to current § 615.5134(c) need to be increased for certain types of investments;

(6) Counterparty risk needs to be reduced; and

(7) Liquidity policies need to take into account the continuing uncertainty as to whether the Federal Reserve System would provide a line of credit to FCS banks under section 13(3) of the Federal Reserve Act during a systemic liquidity crisis.

As our colleagues at international financial regulators and the Federal banking agencies are doing, we are drawing conclusions from the lessons that we learned during recent crises. As a result, we are revising our regulatory and supervisory approaches towards liquidity so that System institutions are in a better position to withstand whatever future crises may arise. As part of our ongoing efforts to limit the adverse effect of rapidly changing economic, financial, and market conditions on the liquidity of any FCS bank,[11] we now propose amendments to § 615.5134 that would redress these vulnerabilities.

III. Section-by Section Analysis of the Proposed Rule

A. Section 615.5134(a) – Liquidity Policy

The board of directors is responsible for ensuring that the bank always has readily available funds to continue operations and pay maturing obligations. The board discharges this responsibility by adopting policies and procedures for management to follow. A provision in the existing investment management regulation, § 615.5133(c)(3), requires FCS banks to address liquidity risk in their investment policies. However, the only affirmative requirement that § 615.5133(c)(3) imposes on FCS banks is that their investment policies must describe the liquidity characteristics of eligible investments that they hold to meet their liquidity needs and institutional objectives. Although the existing regulation gives FCS banks ample flexibility to formulate liquidity policies that meet their particular needs and objectives, the FCA is proposing to add a new paragraph (a) to § 615.5134 that for the first time, would require each FCS bank to address other specific issues in its liquidity policies. The banks have the option of either incorporating these new liquidity policies in their investment management policies required under § 615.5133, or in a separate document.

Proposed § 615.5134(a) addresses the board's responsibility for establishing and implementing liquidity policies for the bank. Proposed § 615.5134(a)(1) would require the board of directors of each FCS bank to adopt written liquidity policies that are consistent with the investment management policies that the board adopts under § 615.5133. The guidance that the FCA has provided to FCS banks about investment management policies and practices in § 615.5133 also applies to their liquidity policies.[12] The FCA expects the bank's liquidity policies to be consistent with, and fit into its overall investment strategy. Liquidity risk management is critically important to the long-term viability of the bank, and for this reason, it must be integrated into the bank's overall investment management and risk management processes.[13]

In discharging its responsibility, the board must establish appropriate strategies, policies, procedures, and limits that will enable the bank to monitor, measure, manage, and mitigate liquidity risk.[14] The board's policy should provide adequate guidance to management as it develops and implements strategies for managing liquidity risk. At a minimum, the policy should provide clear direction to management about limiting and controlling risk exposures, and keeping them within the board's risk tolerance levels. Additionally, these policies should establish parameters that enable management to determine whether particular investments belong in the liquidity reserve given their potential suitability for managing interest rate risks.

Proposed § 615.5134(a)(1) would also require the board to: (1) Review its liquidity policies at least once every year; (2) affirmatively validate the sufficiency of its liquidity policies; and (3) make any revisions it deems necessary. The purpose of this provision is to compel every FCS bank board to ascertain whether its policies enable the bank to respond promptly and effectively to events that may occur and threaten its liquidity. More specifically, the board should determine, as part of its review, whether its current policies enable the bank to consistently maintain sufficient liquidity for its ongoing funding needs, thus covering both expected and unexpected deviations in the availability of funds to meet cash demands.[15] A bank's viability often depends on effective liquidity risk management (that is fully integrated into its overall risk management strategies and processes), and the annual review should determine whether the policies achieve these objectives.[16] As part of its review, the bank board should consider whether it needs to adjust its liquidity policies based both on past experiences and on expected trends in the economy, agriculture, and financial markets.

The final provision of proposed § 615.5134(a)(1) would require the board to ensure that adequate and effective internal controls are in place, and that management complies with and carries out the bank's liquidity policies. Besides preventing losses caused by fraud or mismanagement, strong internal controls will enable FCS banks to respond more quickly and effectively when significant market turmoil arises and impedes access to funding.

The content of the board's liquidity policies are the focus of § 615.5134(a)(2). This regulatory provision identifies seven different issues that, at a minimum, a bank must address in its liquidity policies. The bank's policies should be comprehensive and commensurate with the complexity of the bank's operations and risk profile.

Proposed § 615.5134(a)(2)(i) would require policies to address the purpose and objectives of the liquidity reserve. This section of the bank's policies should distinguish the purpose and objectives of the liquidity reserve from the other operations and asset-liability functions of the bank, including interest rate management. The board's philosophy and position on the purpose and objectives of the liquidity reserve are of prime importance to effective liquidity management at the bank. In normal times, access to the debt markets provides the System with ready liquidity. However, when market access is impeded, the liquidity reserve should enable each FCS bank to maintain sufficient cashflows to pay its obligations, meet its collateral needs, and fund operations in a safe and sound manner.[17]

In normal times, FCS banks may pay more attention to the financial performance of the liquidity reserve rather than its role as an emergency source of funding. Incorrectly prioritizing these two objectives is problematic because the liquidity reserve should consist of cash and high-quality investments that can be quickly converted into cash at, or close to, par value. Cash-like investments pose little risk to the investor and, therefore, they usually do not earn the highest rate of return.

During the crisis in 2008, some FCS banks experienced losses that were larger than expected given the primary purpose of the liquidity reserve is an emergency source of funding. The FCA expects FCS banks to select investments for the liquidity reserve by their liquidity characteristics, and to match these assets closely to the bank's maturing liabilities. Choosing investments primarily for their ability to generate revenue is fundamentally incompatible with the System's GSE status.[18] Pursuant to proposed § 615.5134(a)(2)(i), the board should provide guidance to management about these issues when it addresses the objectives and purposes of the liquidity reserve in its policies.

Proposed § 615.5134(a)(2)(ii) would require the board's policies to address the diversification of the liquidity reserve portfolio. This diversification requirement would apply to both the liquidity reserve in proposed § 615.5134(e) and the supplemental liquidity buffer in proposed § 615.5134(f). Diversification by tenor, issuer, issuer type, size, asset type, and other factors can reduce certain investment risks. The bank's diversification policy should address the board's desired mix of cash and investments that the bank should hold for liquidity under a variety of scenarios, including both normal and adverse conditions. Within the spectrum of eligible qualified investments, proposed § 615.5134(a)(2)(ii) would require the policy to establish criteria for diversifying these assets based on issuers, maturity, and other factors that the bank deems relevant. In formulating these criteria, each bank should consider, in light of its needs and circumstances, how diversification would better enable the liquidity reserve and supplemental liquidity buffer to serve as its emergency or supplemental funding source when market access is curtailed or fully impeded. The FCA expects each bank to tailor its policy to its individual circumstances and financial conditions, and to revise it in response to changes in the business environment.

Proposed § 615.5134(a)(2)(iii) would require the board's policies to establish maturity limits and credit quality standards for investments that the bank is holding in its liquidity reserve. This aspect of the bank's policies would help management to target and match cash inflows from loans and investments to outflows that pay its maturing obligations. In devising its diversification strategy the bank should consider how it may need to rely on its liquidity portfolio as an available funding source in the short-, intermediate-, and long-term. As high-quality investments season and come closer to maturity, they

become more liquid. In this context, a well-reasoned policy should guide management about deploying the strata of investments throughout the liquidity reserve and the supplemental liquidity buffer.

Proposed § 615.5134(a)(2)(iii) also focuses on the credit quality standards that board policies should establish for investments that the bank will hold to meet the liquidity reserve requirements of this regulation. Investments with short terms to maturity and high credit quality tend to be liquid and, therefore, are generally suitable for the bank's liquidity reserve and supplemental liquidity buffer. The preamble to § 615.5134(c) below, will discuss many of the attributes of high-quality liquidity investments in greater detail. The bank's liquidity policies should base credit quality standards for investments on factors and standards that the financial services industry uses to determine that the risk of default for both the asset and its issuer are negligible. In determining the credit quality of a security, FCS banks may consider the credit ratings issued by a Nationally Recognized Statistical Rating Organization (NRSRO), but may not rely solely or disproportionately on such ratings. System banks must document their credit quality determinations.

Under proposed § 615.5134(a)(2)(iv), the board's policies should cover the target amount of days of liquidity that the bank needs based on its business model and its risk profile. Estimating the target amount of days of liquidity that the bank will need to outlast various stress events is an effective tool for managing and mitigating liquidity risks. The FCA expects each FCS bank to include a prudent amount of unfunded commitments in its calculation of the target amount of days of liquidity it will need to survive a liquidity crisis in the markets.

Proposed § 615.5134(a)(2)(v) would require the bank's policies address the elements of the Contingency Funding Plan (CFP) in paragraph (h) of the proposed rule. The purpose of the CFP is to address unexpected events or unusual business conditions that increase liquidity risk at FCS banks. Our existing regulation, § 615.5134(d), requires each FCS bank to have a formal written CFP to address liquidity shortfalls that may occur during market disruptions. The proposed rule would strengthen contingency funding planning at FCS banks. Under proposed § 615.5134(a)(2)(v), an effective CFP would cover at a minimum: (1) Strategies, policies, and procedures to manage a range of stress scenarios; (2) chains of communications and responsibility within the bank; and (3) implementation of the CFP during all phases of an adverse liquidity event. The preamble to proposed § 615.5134(h) will discuss the substantive requirements of the CFP and our expectations of FCS banks in greater detail.

The next provision of this regulation, proposed § 615.5134(a)(2)(vi), covers delegations of authority pertaining to the liquidity reserve in the bank's liquidity policies. As with all other aspects of the bank's operations, an explicit delegation of authority within a clearly defined chain of command strengthens the effectiveness and efficiency of an institution's operations and mitigates the risk of loss. The purpose of a delegation of authority is to clearly establish lines of authority and responsibility for managing the bank's liquidity risk.[19] The policies should clearly identify those individuals and committees that are responsible for making decisions involving liquidity risk and implementing risk mitigation strategies. Additionally, the policies should ensure that the ALCO has sufficiently broad representation across the operational functions of the bank that influence the bank's liquidity risk profile.

Under proposed § 615.5134(a)(2)(vii), the policies must contain reporting requirements, which at a minimum, would require management to report to the board at least once every quarter about compliance with the bank's liquidity policies, and to what extent the liquidity reserve portfolio has achieved the bank's liquidity objectives. This provision would also require management to report immediately to the board about any deviation from its liquidity policies, or any failure to meet the liquidity targets in the board's policies. The purpose of this provision is to ensure that an effective reporting process is in place, and management communicates accurate and timely information to the

board about the level and sources of the bank's exposure to liquidity risk. These reports should enable the board to take prompt corrective action. The board should also consider these quarterly reports when it conducts its annual review of the bank's liquidity policies and decides whether to make any revisions to its policies, pursuant to proposed § 615.5134(a)(1).

B. Liquidity Reserve Requirement - § 615.5134(b)

Proposed § 615.5134(b) is the cornerstone of the FCA's proposal because it articulates the core liquidity reserve requirements for FCS banks. Proposed § 615.5134(b) is not a departure from the liquidity reserve requirement in FCA's existing liquidity regulation. Instead, it builds upon and strengthens the concepts, principles, and requirements of existing § 615.5134. The purpose of proposed § 615.5134(b) is to better prepare FCS banks so they can withstand future liquidity crises. The FCA designed this proposal to address the vulnerabilities identified during recent crises. In developing proposed § 615.5134(b), we also considered the Basel Committee's recommendations for an international framework for liquidity, and the Federal banking agencies' Interagency Policy Statement on Funding and Liquidity Risk Management.

Both the existing and proposed regulations require each FCS bank to maintain a liquidity reserve sufficient to fund 90 days of the principal portion of maturing obligations and other borrowings of the bank at all times. However, in contrast to the existing regulation, proposed § 615.5134(b) and (e) would divide the bank's liquidity reserve into two levels. The first level of the liquidity reserve would fund a bank's maturing obligations and operations for the first 30 days from the onset of a significant stress event. Cash and certain instruments that mature within 3 years or less must comprise at least 15 days of the first level of the bank's liquidity reserve. The bank would draw on the second level of the reserve if market turmoil continued to persist for the subsequent 60 days after the initial 30 days thereby comprising together a stratified 90-day liquidity reserve.

Proposed § 615.5134(b) would require FCS banks, for the first time, to maintain a supplemental liquidity buffer pursuant to proposed § 615.5134(f). The new regulation would require each FCS bank to hold supplemental liquid assets (comprised of cash and other qualified assets listed in § 615.5140) in excess of the 90-day minimum liquidity reserve. The supplemental liquidity buffer would complement the 90-day liquidity reserve, and its purpose is to enable each FCS bank to continue operations if market access becomes impeded for a prolonged period of time in differing stress scenarios.

Proposed § 615.5134(b) would also require FCS banks to discount the assets in their liquidity reserve by the percentages specified in proposed § 615.5134(g). Although the existing regulation already requires FCS banks to discount assets in the liquidity reserve, the proposed rule would change some of the percentages to reflect the new two-tier structure of the liquidity reserve. The preamble to proposed § 615.5134(g) discusses in detail how we are revising the discounting requirements for the liquidity reserve.

The final sentence of proposed § 615.5134(b) states that the liquidity reserve must be comprised only of cash, including cash due from traded but not yet settled debt, and qualified eligible investments under § 615.5140 that are marketable under proposed § 615.5134(d). Proposed § 615.5134(b) is similar, but not identical, to existing § 615.5134(a). Both the existing and the proposed rule specify that the liquidity reserve must be comprised of cash, including cash due from traded but not yet settled debt, and investments listed in § 615.5140.

The final sentence of proposed § 615.5140(b), however, differs from existing § 615.5140(a) in two crucial respects. First, the proposed rule emphasizes that all investments held in liquidity reserves must be marketable. As the preamble to proposed § 615.5134(d) explains in greater detail below, the new

regulation would establish specific regulatory benchmarks for determining whether particular investments are marketable. Marketability of a security is an essential attribute of its liquidity and helps determine its suitability for the liquidity reserve.

Second, the proposed rule would repeal the provisions in existing § 615.5134(a) that impose specific credit ratings on investments that FCS banks hold in their liquidity reserves. Under the existing regulation, money market instruments and floating and fixed rate debt securities held in the banks' liquidity reserve must maintain one of the two highest NSRSO credit ratings. In the event that an unrated instrument is in the liquidity reserve, the existing regulation requires the issuer to carry one of the two highest NRSRO ratings. Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act[20] requires each Federal agency to: (1) Review any references or requirements in its regulations concerning the credit ratings of securities and money market instruments, and (2) replace references to, and requirements that regulated entities rely on such credit ratings with standards of creditworthiness that the agency determines is appropriate. In making this determination, every agency must seek to establish, to the extent feasible, uniform standards of creditworthiness. Our proposed liquidity regulation does not seek to replace the NRSRO rating requirements in existing § 615.5134(a) with a specific alternate standard of creditworthiness. Instead, we propose to require FCS banks to hold investments in the liquidity reserve that are unencumbered under proposed § 615.5134(c), and are marketable under proposed § 615.5134(d). In two other rulemakings, the FCA has invited the public to suggest options for replacing NRSRO credit ratings with other standards to determine the creditworthiness of financial instruments and their issuers.[21] We also solicit your comments and suggestions about the best approach for addressing standards of creditworthiness for investments held in the liquidity reserves of FCS banks.

C. Unencumbered and Marketable Investments in the Liquidity Reserve

Currently, existing § 615.5134(b) states that all investments that an FCS bank holds for the purpose of meeting its regulatory liquidity reserve requirement must be free of lien. Proposed § 615.5134(c) would expand upon this concept by requiring FCS banks to hold only unencumbered investments in their liquidity reserves. Under proposed § 615.5134(c), an asset is unencumbered if it is free of lien and is not explicitly or implicitly pledged to secure, collateralize, or enhance the credit of any transaction.[22] Additionally, proposed § 615.5134(c) also would prohibit any FCS bank from using an investment in the liquidity reserve as a hedge against interest rate risk pursuant to § 615.5135 if liquidation of that particular investment would expose the bank to a material risk of loss. Unencumbered investments are free of the impediments or restrictions that would otherwise curtail the bank's ability to liquidate them to pay its obligations when normal access to the debt market is obstructed. Proposed § 615.5134(c) strengthens the liquidity of FCS banks and improves the safety and soundness of the Farm Credit System as a whole.

Under both proposed § 615.5134(b) and (d), all eligible investments that FCS banks hold in their liquidity reserves must be marketable. Proposed § 615.5134(d) specifies the criteria and attributes that determine whether investments are marketable for the purposes of this regulation. Investments that meet all the marketability criteria in proposed § 615.5134(d) would be deemed to possess the characteristics of high-quality liquid assets that are suitable for the liquidity reserves at FCS banks. Proposed § 615.5134(d) is based on many of the concepts that the Basel Committee articulated in the Basel III Liquidity Framework.[23] The FCA tailored these concepts to the unique structure, needs, and circumstances of the FCS.

Proposed § 615.5134(d)(1) states that an investment is marketable if it can be easily and immediately converted into cash with little or no loss in value. Investments that exhibit this attribute are more likely to generate funds for the bank without incurring steep discounts even if they were liquidated

in a "fire sale" during turmoil in the markets.[24] The liquidity of an asset depends on its performance during a stress event, and is measured by the amount that the holder can convert into cash within a certain timeframe.[25]

On a related note, proposed § 615.5134(d)(1) complements the definition of "liquid investments" in existing § 615.5131(e).[26] The existing regulation defines "liquid investments" as "assets that can be promptly converted into cash without significant loss to the investor.[27] We do not consider § 615.5131(e) to be redundant or inconsistent with proposed § 615.5134(d)(1). For this reason, we do not propose to repeal or amend § 615.5131(e). However, we invite your comments about whether the final rule should retain, relocate, or modify § 615.5131(e).

Another feature of a marketable investment is that it exhibits low credit and market risks, and we propose to incorporate this criterion into proposed § 615.5134(d)(2). Assets tend to be more liquid if they are less risky. An investment has low credit risk if its issuer has a strong credit standing, is not heavily indebted, and its assets are not heavily leveraged. Low duration[28] and low volatility indicate that an investment is more likely to be liquid because it has low market risk.[29]

Ease and certainty of valuation is also an attribute of marketable investments.[30] We are incorporating this concept into proposed § 615.5134(d)(3). The liquidity of an asset is likely to increase if market participants are able to agree on its valuation. An instrument has ease and certainty of valuation if the components of its pricing formulation are publicly available. The pricing of high-quality liquid assets are usually easy to calculate because they do not depend significantly on numerous assumptions. In practice, proposed § 615.5134(d)(3) effectively excludes structured investments from the liquidity reserves at FCS banks, although banks may hold such assets in their supplemental liquidity buffers if they are eligible investments under § 615.5140. The proposed rule, however, would allow FCS banks to hold mortgage-backed securities issued by the Government National Mortgage Association in their liquidity reserves because they are highly marketable securities backed by the full faith and credit of the United States.

Under proposed § 615.5134(d)(4), the final attribute of a marketable investment is that it can be easily bought or sold. Money market instruments generally qualify as marketable investments under this provision because they are easily bought and sold even though they are not traded on exchanges. Otherwise, marketable investments include assets listed on developed and recognized exchange markets. Listing on a public exchange enhances the transparency of the pricing mechanisms of investments, thus enhancing their marketability and liquidity.[31] Investments would also comply with the requirement of proposed § 615.5134(d)(4) if investors can sell or convert them into cash through repurchase (repo) agreements in active and sizeable markets. For the purpose of this proposed rule, markets are active and sizeable if they have a large number of market participants, high-trading volume, and investors can sell or repo the asset at any time.[32] Many securities that System banks hold in their liquidity reserves are traded in high volume. Nevertheless, the FCA cautions that the potential volume that an FCS bank trades or holds in a particular security should not constitute a significant percentage of the overall trading volume in that security. Another feature of an active and sizeable market is that it historically has market breadth and market depth.[33] Proposed § 615.5134(d)(4) would exclude private placements from the banks' liquidity reserves, but not the supplemental liquidity buffer.

D. Composition of the Liquidity Reserve

Proposed § 615.5134(e) governs the composition of the liquidity reserve. This provision would require each FCS bank to continuously hold cash and the investments identified in the table to proposed §

615.5134(e) to meet the 90-day minimum liquidity reserve requirement of this regulation. Under this proposal, each bank would also apply the discounts in proposed § 615.5134(g) to all cash and investments that it holds in its liquidity reserve.

Although the existing regulation already requires every FCS bank to maintain a sufficient stock of liquid assets to fund its maturing obligations and other borrowings for at least 90 days, the proposed rule would divide the liquidity reserve into two levels. The first level of the liquidity reserve would provide sufficient liquidity for the bank to pay its obligations and continue operations for 30 days, whereas the second level of the reserve would cover the following 60 days. Taken together, the two levels of the liquidity reserve should provide each FCS bank with adequate liquidity for 90 days.

Proposed § 615.5134(e) would require FCS banks to hold a minimum of 90 days of cash and liquid investments in their liquidity reserves. In other words, FCS banks may need to exceed 90 days based on their individual liquidity needs. The FCA expects each bank, in accordance with its policies and procedures, to determine the appropriate level, size, and quality of its liquidity reserve based on its liquidity risk profile. Determining and maintaining an adequate level of liquidity depends on each bank's ability to meet both expected and unexpected cash flows and collateral needs without adversely affecting its daily operations and financial condition.[34] Additionally, the size and level of the liquidity reserve should correlate to the bank's ability to fund its obligations at reasonable cost.[35] Each FCS bank must document and be able to demonstrate to FCA examiners how its liquidity reserve mitigates the liquidity risk posed by the bank's business mix, balance sheet structure, cash flows, and on- and off-balance sheet obligations.[36] Matching the size, level, and composition of the liquidity reserve to obligations that are maturing in a prescribed number of days is a sound banking practice, and is consistent with GSE status.

The proposed rule would require each FCS bank to maintain sufficient quantity of highly liquid assets in the first level of its liquidity reserve so it could continue normal operations for 30 days if a national security emergency, a natural disaster, or intense economic or financial turmoil impedes System access to the markets. As the first item in the left column of the table states, investments in the first level of the liquidity reserve would be available for the bank to sequentially apply to pay obligations that mature starting on day 1 through day 30.

Under the second provision in the left-hand column of the table, cash and instruments with a final maturity of 3 years or less must comprise at least 15 days of the first level of the liquidity reserve. As a result, the proposed rule would mandate that each bank have enough cash and short-term, highly liquid assets on hand so it could pay its obligations and fund its operations for 15 days if the debt markets were closed, or the System's cost of funding became uneconomical. FCS banks would draw first on this 15-day sublevel in the event of significant stress event.

The right side of the table identifies the assets that proposed § 615.5134(e) would require FCS banks to hold in Level 1 of their liquidity reserves. Again, all of these assets are highly liquid because they are cash, or investments that are high quality, close to their maturity, and marketable. All of the assets that banks hold in their liquidity reserve would be subject to the discounts specified in proposed § 615.5134(g).

Under the proposed rule, FCS banks are authorized to hold five classes of assets in the first level of their liquidity reserve. These assets are:

- Cash –
  - (1) Cash balances on hand,
  - (2) Cash due from traded but not yet settled debt, and

(3) Insured deposits that FCS banks hold at federally insured depository institutions in the United States;

- United States Treasury securities –
  Each FCS bank must select Treasury securities that have final maturities and other characteristics that best enables it to fund operations if market access becomes obstructed;

- Other marketable obligations explicitly backed by the full faith and credit of the United States;[37]

- Government-sponsored agency senior debt securities that mature within 60 days (debt obligations of the FCS are excluded);[38]

- Diversified investment funds that are comprised exclusively of Level 1 instruments.

As discussed earlier, the second level of the liquidity reserve would provide FCS banks with sufficient liquidity to fund their obligations and continue normal operations starting on day 31 through day 90. Under proposed § 615.5134(e), FCS banks would use the assets in Level 2 during a prolonged stress event to fund obligations that mature during the subsequent 60 days of the 90-day liquidity reserve.

The proposed rule would authorize FCS banks to hold the five following classes of assets in the second level of their liquidity reserves:

- Additional amounts of Level 1 instruments;
- Government-sponsored agency senior debt securities with maturities that exceed 60 days;[39]
- Government-sponsored agency mortgage-backed securities;
- Money market instruments that mature in 90 days; and
- Diversified investment funds that are comprised exclusively of Levels 1 and 2 instruments.

Unfunded commitments are another issue that raises concerns for the FCA. FCS banks or their affiliated associations often have outstanding lines of credit to borrowers who may draw funds to meet their seasonal business needs. FCS banks and associations can be legally obligated to fund these commitments. A sudden surge in borrower demand for funds under these lines may impair the bank's liquidity at a time when market access is becoming impeded. For this reason, it is important that FCS banks adequately account for unfunded commitments and other contingencies, including those that are off balance sheet, when they calculate the amount and quality of liquid assets they need in their liquidity reserve to fund all maturing and contingent obligations during a particular time period. Each FCS bank has its own unique circumstances and risk profile and, therefore, exposure to unfunded commitments and other contingent obligations varies within the FCS.

Unfunded commitments and other material contingent obligations, including those off balance sheet, potentially expose both FCS and other financial institutions to significant safety and soundness risks. Accordingly, contingent outflows raise substantial regulatory concerns for the FCA and other financial regulators.[40] Proposed § 615.5134(e) does not specifically require FCS banks to maintain sufficient assets in the liquidity reserve to cover unfunded commitments and other contingent obligations. However, the FCA is contemplating whether to add a specific provision to the final regulation that would require the liquidity reserve to adequately cover unfunded commitments and other contingent obligations. Requiring FCS banks to hold sufficient liquidity to cover these contingencies could mitigate risks that pose a threat to the liquidity, solvency, and ultimate viability of FCS banks. However, such a requirement

could also impose significant opportunity costs on FCS banks in that they would be compelled to provide for these contingencies with cash and short-term liquid investments.

The FCA considers the guidance of the Federal banking agencies and the Basel III Liquidity Framework in developing this proposed rule on liquidity, and evaluates whether it is appropriate for System banks. Specifically, the Basel Committee currently suggests that regulated entities account for unfunded commitments and other contingent obligations in their liquidity reserve calculations. We are evaluating to what extent we should incorporate the approach of the Basel III Liquidity Framework into our regulation.

For this reason, we solicit your responses to the following questions:

- Should the final rule explicitly require the liquidity reserve to cover unfunded commitments and other contingent obligations? In your opinion, what would be the advantages and disadvantages of adding this requirement to § 615.5134(e)?
- Should the FCA consider more stringent liquidity reserve requirements based on size and complexity of different FCS banks, or should the liquidity reserve requirements remain the same for all System banks?
- What cash inflows and outflows identified in the Basel III Liquidity Framework are relevant to System banks? For those that are relevant, how should we incorporate them into our regulation?
- Should we incorporate the Basel III Liquidity Framework stress parameters in the liquidity reserve requirement for System banks? If so, which ones? For those, please indicate what percentage of the unfunded commitments and other contingent obligations the FCS bank should cover in its liquidity reserve.
- How should an association's direct loan under the General Financing Agreement and its accompanying contingent commitments factor into the funding bank's liquidity reserve requirement?

Please provide any information or data concerning unfunded commitments and other contingent obligations that support your answers to the above questions.

E. <u>Supplemental Liquidity Buffer</u>

Proposed § 615.5134(f) would introduce a new concept into the FCA's liquidity regulation by requiring all FCS banks to establish and maintain a supplemental liquidity buffer that would provide a longer term, stable source of funding beyond the 90-day minimum liquidity reserve. The supplemental liquidity buffer would complement the 90-day minimum liquidity reserve. Whereas the primary purpose of the 90-day minimum liquidity reserve is to furnish sufficient short-term funding to outlast an immediate crisis, the supplemental liquidity buffer would enable FCS banks to manage and mitigate their liquidity risk over a longer term horizon. Besides providing FCS banks with longer term and stable source of funding, each bank would be able to draw on the supplemental liquidity buffer if a heavy demand for funds strains its 90-day minimum liquidity reserve during a significant stress event. The supplemental liquidity buffer is an additional stock of assets that would provide stable, longer term funding of the bank's operations beyond the first 90 days.

The proposed rule does not specify the length of time that the supplemental liquidity buffer should cover. The Basel Committee on Banking Supervision recommends that a supplemental reserve should provide depository institutions and related banking organizations stable, long-term funding over a 1-year time horizon. We invite your comments about whether our final rule should establish a specific

time horizon for the supplemental liquidity buffer at FCS banks. If you believe that we should establish a specific timeframe for the supplemental liquidity buffer, please tell us what you think it should be, and why. If you oppose a specific regulatory time horizon for the supplemental liquidity buffer, please explain your reasoning. We are also interested in hearing your views about how the similarities and differences between FCS banks and financial institutions under the supervision of other Federal and international regulators influence the answers to our questions about potential time horizons for the supplemental liquidity buffers at FCS banks.

The first sentence of proposed § 615.5134(f) would require each Farm Credit bank to hold supplemental liquid assets in excess of the 90-day minimum liquidity reserve. Again, the supplemental liquidity buffer consists of the amount of stable longer term funding that a FCS bank has available, and it should match the amount of stable funding that the bank needs to operate during a prolonged period of time. For the purposes of proposed § 615.5134(f), stable funding means that the instruments in the supplemental liquidity buffer are expected to furnish the bank with a reliable source of funds over a longer term time horizon under conditions of extended stress. The amount and composition of the supplemental liquidity buffer at a particular bank ultimately depends on a number of different factors pertaining to its operations, including the funding of its assets and liabilities, off-balance sheet items, and contingent exposure, such as unfunded commitments.

According to the second sentence of proposed § 615.5134(f), the supplemental liquidity buffer must be comprised of cash and qualified eligible investments listed in § 615.5140 of this part. Thus, the proposed rule would allow FCS banks to hold qualified eligible investments (listed in § 615.5140) in their supplemental liquidity buffer that they could not hold in their 90-day liquidity reserve. However, the FCA expects each FCS bank to calibrate the quality and quantity of assets that it selects for the supplemental liquidity buffer to the amount of funding it will need to outlast significant stress scenarios. Each bank should configure its supplemental liquidity buffer so it realistically corresponds to the demands of its liquidity risk profile.

The third sentence of proposed § 615.5134(f) states that each FCS bank must be able to liquidate any qualified investment in its supplemental liquidity buffer within the timeframe established in the bank's liquidity policies at no less than 80 percent of its book value. The fourth sentence of proposed § 615.5134(f) would require an FCS bank to remove from its supplemental liquidity buffer any investment that has, at any time, a market value that is less than 80 percent of its book value. These two provisions are designed to limit loss that the bank might incur on qualified investments that it holds in its supplemental liquidity buffer. From the FCA's perspective, the liquid and marketable characteristics of qualified investments in the supplemental liquidity buffer would be called into question if their market value falls 20 percent or more below their book value. In all probability, an FCS bank could no longer convert such assets easily or immediately into cash at little or no loss in value. Additionally, a qualified investment that has lost 20 percent or more of its book value no longer exhibits low credit or market risks. The proposed rule would instill strong discipline and control by requiring FCS banks to remove from their supplemental liquidity buffer an investment that has depreciated 20 percent or more off its book value. We invite your comments on the maximum percentage that the final rule should allow the market value of an asset to depreciate from its book value before the bank must remove it from the supplemental liquidity buffer.

Finally, proposed § 615.5134(f) would require the amount that each bank holds in its supplemental liquidity buffer, at a minimum, to: (1) Adhere to the requirements of the board's liquidity policies; (2) provide excess liquidity beyond the days covered by the 90-day minimum liquidity reserve; and (3) enable the bank to meet the needs of its CFP. The supplemental liquidity buffer is a stable longer term funding source that enables each bank, based on its business and risk profiles, to match the inflow

and outflow of funds from its assets and liabilities.

F. Discounts

Our existing liquidity regulation requires FCS banks to discount assets in their liquidity reserves. Existing § 615.5134(c) specifies the discount percentage that applies to particular classes of assets. We propose to revise the provision in the rule pertaining to discounts so they are more appropriate to the new regulatory structure, which splits the liquidity reserve into two levels, establishes a supplemental liquidity buffer, and greatly strengthens contingency funding planning at FCS banks.

Discounts approximate the cost of liquidating investments over a short period of time during adverse situations. The system of discounting assets is designed to accurately reflect true market conditions. For example, the proposed rule would assign only a minimal discount to investments that are less sensitive to interest rate fluctuations because they are exposed to less price risk. Conversely, the discount for long-term fixed rate instruments is higher because they expose FCS banks to greater market risk.

Accordingly, the FCA proposes the following discounts for the classes of assets that FCS banks hold in their liquidity reserves and supplemental liquidity buffers:

Instrument	Multiply by
Cash and overnight investments	100 percent
United States Treasuries	97 percent of market value
All other Level 1 instruments including such instruments held in Level 2 to fund obligations maturing on day 31 through day 90	95 percent of market value
All Level 2 instruments	93 percent of market value
All other qualified investments held for meeting the bank's liquidity policy and contingency plans unless they merit the discount for Level 1 or Level 2 instruments	85 percent of market value

G. Contingency Funding Plan

Contingency funding planning is an essential and crucial element of effective liquidity risk management at all financial institutions. The CFP is a blueprint that helps financial institutions respond to contingent liquidity events, which are unexpected events or conditions that may increase liquidity risk.[41] Contingent liquidity events may arise from external factors that adversely affect the financial system, or they may be specific to the conditions at an individual institution.[42]

Since 2005, our regulation has required all FCS banks to have a contingency funding plan that addresses liquidity shortfalls during market disruptions. Existing § 615.5134(d) also requires the board of directors of each FCS bank to review the contingency funding plan every year and make any necessary changes. The crisis in 2008 revealed actual and potential vulnerabilities in contingency planning at FCS banks. As a result, the FCA proposes to strengthen contingency planning at FCS banks by amending the applicable provisions of our liquidity regulation. These amendments should reinforce the wherewithal of FCS banks to withstand future crises.

The first sentence of proposed § 615.5134(h) would require each FCS bank to have a CFP to ensure sources of liquidity are sufficient to fund normal operations under a variety of stress events. Whereas existing § 615.5134(d) only requires the CFP to address liquidity shortfalls caused by market disruptions, proposed § 615.5134(h) would require the CFP to explicitly cover other stress events that threaten the bank's liquidity. In addition to market disruptions, the proposed rule would require the CFP to specifically address:

(1) Rapid increases in loan demand;
(2) Unexpected draws on unfunded commitments;
(3) Difficulties in renewing or replacing funding with desired terms and structures;
(4) Pledging collateral with counterparties; and
(5) Reduced market access.

Each of these events could weaken the bank's liquidity and impair its access to funding during a crisis.

The second sentence of proposed § 615.5134(h) would require each Farm Credit bank to maintain an adequate level of unencumbered and marketable assets in its liquidity reserve that could be converted into cash to meet its net liquidity needs based on estimated cash inflows and outflows for a 30-day time horizon under an acute stress scenario. As an integral and critical part of contingency planning, each FCS bank should quantitatively project and evaluate its expected funding needs and its available funding

sources during likely stress scenarios. More specifically, each FCS bank must realistically assess and analyze its cash inflows, cash outflows, and its access to funding at different phases of a potential, but acute liquidity stress event that continues for 30 days. In addition to a realistic assessment of potential cash-flow mismatches that may occur during different intervals of various stress events, effective contingency planning also requires the bank to evaluate whether it has a sufficient amount of marketable assets that it can convert into cash and continue operations for the duration of any potential crisis.

The next provisions of proposed § 615.5134(h) would require the CFP to address four specific areas that are essential to the bank's efforts to mitigate its liquidity risk. Taken together, these four provisions require each bank to have an emergency preparedness plan in place so it can effectively cope with a full range of contingencies that could endanger its liquidity, solvency, and viability.

First, proposed § 615.5134(h)(1) would require each FCS bank to customize the CFP to its individual financial condition and liquidity risk profile and the board's liquidity risk tolerance policy. The CFP is part of the bank's overall liquidity policies, and as such, it should be commensurate with the complexity, risk profile, and scope of the bank's operations.[43] The CFP should cover a number of plausible scenarios that could adversely affect the bank's liquidity. In this context, the CFP should address contingencies that are both:

- Highly probable, but would have a low impact on the bank's liquidity; and
- Less likely to occur but would have a significant impact on the bank's liquidity.[44]

The CFP should identify stress events that could have a significant impact on the bank's liquidity based on its individual circumstances, such as its balance sheet structure, business model, and organizational configuration.[45] The CFP should also assess how different stress events are likely to affect the bank's liquidity.

Under proposed § 615.5134(h)(2), the CFP must identify funding alternatives that the Farm Credit bank can implement whenever its access to funding is impeded. For the purposes of proposed § 615.5134(h)(2), funding alternatives include, at a minimum, arrangements for pledging collateral to secure funding and possible initiatives to raise additional capital. Each bank must be able to readily access its contingent funding sources during a stress event. The FCA expects every FCS bank to take appropriate measures, including advance planning and periodic testing, so it always has reliable funding alternatives available when normal market access becomes impeded.

Pursuant to proposed § 615.5134(h)(3), the CFP must require the bank to conduct periodic stress testing in order to analyze the possible impacts on the bank's cash inflows and outflows, liquidity position, profitability and solvency under a variety of stress scenarios. Periodic stress testing of its anticipated cash flows would enable the bank to estimate future funding surpluses and shortfalls under several different stress scenarios, which in turn, affects the bank's ability to fund its assets, liabilities, and operations throughout adverse situations.

Proposed § 615.5134(h)(4) would require each bank's CFP to establish a process for managing events that imperil its liquidity. This includes assigning appropriate personnel and having executable action plans to implement the CFP. Under this provision, the CFP would establish a framework for the bank to monitor contingent events that potentially threaten its liquidity. This framework should contain mechanisms, such as early-warning indicators and event triggers,[46] which are tailored to the bank's liquidity profile. These early-warning systems help the bank to identify potential adverse liquidity events that are looming on the horizon. This enables the bank to position itself and be ready for the various phases of the stress event as it evolves.

The second prong of proposed § 615.5134(h)(4) involves internal controls and management of contingency events. The CFP should establish a reliable crisis management team. Frequent communication and reporting among team members, management, and the board optimize the effectiveness of the CFP during a liquidity crisis by coordinating the bank's response and diminishing liquidity risks to the bank's operations.[47] The CFP should also identify the processes and procedures that the bank will use to manage any evolving crisis.

The final sentence of proposed § 615.5134(h) would require the board of directors of each FCS bank to review and approve the CFP at least once every year, and incorporate adjustments to reflect changes in the bank's risk profile and market conditions. Internal conditions and the external environment in which the FCS operates may shift, either gradually or suddenly, thus affecting the liquidity risk profile of each bank. The FCA expects each FCS bank to constantly monitor fluctuations in its operating environment and react effectively so it can quickly stem potential damage to its liquidity, solvency, and viability. Reviewing the CFP at least once every 12 months and more frequently as conditions warrant, is a necessary tool for FCS banks to manage and mitigate its liquidity risk.

H. The FCA's Reservation of Authority

In addition to capital, asset quality, management, earnings, and interest rate sensitivity, liquidity is a prime barometer of the financial health, vitality, and viability of financial institutions. Illiquidity indicates that a financial institution is in an unsafe and unsound condition. More than the other indicia of safety and soundness, liquidity is often, but not always, determined by external factors that are beyond the control of FCS banks and other financial institutions. For example, a national defense emergency (such as terrorist attacks), a catastrophic natural disaster, or a macroeconomic or financial crisis could suddenly and without warning close or impede access to the debt markets that FCS banks depend on to fund their normal operations.

Congress designated the FCA as the Federal agency that is responsible for ensuring that all FCS institutions: (1) Comply with all applicable laws; (2) fulfill their public policy mission of extending credit to agriculture, rural utilities, and rural homeowners; and (3) operate safely and soundly. As a result, the Act grants the FCA comprehensive examination, enforcement, and regulatory powers to carry out these duties. The System's liquidity could come under sudden strain when economic uncertainty sparks financial turmoil and, therefore, the FCA must be able to act decisively so all FCS banks meet their obligations and continue operations until the crisis subsides. The FCA has various tools at its disposal to lessen the damage that a liquidity crisis could inflict on the FCS. These tools include exercising its enforcement powers under subtitle C of title V of the Act, and invoking its authority under § 615.5136 to increase the amount of liquid investments that FCS banks may hold in their liquidity reserve during an emergency.

The FCA now proposes to strengthen its supervisory and regulatory oversight of liquidity management at FCS banks. Under proposed § 615.5134(i), the FCA expressly reserves its right to require Farm Credit banks, either individually or jointly, to adjust their treatment of instruments (assets) in their liquidity reserves so they have liquidity that is sufficient and commensurate for the risks they face. This reservation of authority would enable the FCA to respond to adverse financial, economic, or market conditions by requiring any, some, or all Farm Credit bank(s) to take certain prescribed actions to protect FCS liquidity.

More specifically, the FCA reserves the authority under proposed § 615.5134(i) to require one or more FCS bank(s) to:

(1) Apply a greater discount to any individual security or any class of securities;

(2) Shift individual or multiple securities from one level of the liquidity reserve to another, or between one of the levels of the liquidity reserve and the supplemental liquidity buffer based on the performance of such asset(s), or based on financial, economic, or market conditions affecting the liquidity and solvency of the bank;

(3) Spread out or otherwise change concentrations in the allocation of securities in any level of the bank's liquidity reserve and its supplemental liquidity buffer;

(4) Perform additional stress tests using other or different stress criteria or scenarios;

(5) Hold additional liquid assets to cover unfunded commitments and other contingent outflows; or

(6) Take any other action that the Farm Credit Administration deems necessary to ensure that the bank has sufficient liquidity to meet its financial obligations as they fall due.

We invite your comments about any specific scenario that you think we should include in our reservation of authority. We also ask whether you think that there are other actions that the FCA could or should take during a significant stress event so it can act rapidly and decisively to staunch or prevent deterioration in the liquidity position of FCS banks on an individual or collective basis.

IV. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FCA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

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[1] See sections 1.3(a), 2.0(a), 2.10(a), 3.0, 4.25, and 8.1(a)(1) of the Act; 12 U.S.C. 2011(a), 2071(a), 2091(a), 2121, 2211, and 2279aa-1.

[2] See Pub. L. 101-73, sec. 1404(e)(1)(A), 103 Stat. 183, 552-53 (Aug. 9, 1989).

[3] Farm Credit banks (which are the four Farm Credit Banks and the Agricultural Credit Bank) issue and market System-wide debt securities through the Federal Farm Credit Banks Funding Corporation (Funding Corporation). The Funding Corporation, which is established pursuant to section 4.9 of the Act, is owned by all Farm Credit banks.

[4] The Federal Reserve Banks, the Federal Home Loan Banks, and National Credit Union Administration Central Liquidity Facility serve as a source of liquidity for commercial banks, savings associations, and credit unions both in ordinary times and during emergencies.

[5] Section 1101 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended section 13(3) of the Federal Reserve Act, 12 U.S.C. 343(3), to allow the Board of Governors the Federal Reserve System, in consultation with the Secretary of the Treasury, to establish by regulation, policies and procedures that would govern emergency lending under a program or facility for the purpose of providing liquidity to the financial system. Under section 13(3) of the Federal Reserve Act, as amended, the Board of Governors of the Federal Reserve System must establish procedures that prohibit insolvent and failing

entities from borrowing under the emergency program or facility. Pursuant to section 13(3) of the Federal Reserve Act, as amended, the Board of Governors of the Federal Reserve System, with the approval of the Secretary of Treasury could authorize the Federal Reserve Banks to serve as an emergency source of liquidity for the FCS, but it is not obligated to do so. See Pub. L. 11-203, title XI, sec. 1101(a), 124 Stat. 2113 (Jul. 21, 2010).

[6]If market access is completely impeded, the Farm Credit Insurance Fund would also be available to ensure the payments of maturing insured debt obligations. See 12 U.S.C. 2277a-9(c)(1).

[7]The FCA has broad authority under various provisions of the Act to supervise and regulate liquidity management at FCS banks. Section 5.17(a) of the Act authorizes the FCA to: (1) Approve the issuance of FCS debt securities under section 4.2(c) and (d) of the Act; (2) establish standards regarding loan security requirements at FCS institutions, and regulate the borrowing, repayment, and transfer of funds between System institutions; (3) prescribe rules and regulations necessary or appropriate for carrying out the Act; and (4) exercise its statutory enforcement powers for the purpose of ensuring the safety and soundness of System institutions.

[8]For example, financial institutions collectively had difficulty maintaining sufficient short-term liquidity in the aftermath of the attacks on September 11, 2001, and again in September and October of 2008 after several large financial institutions collapsed. During these crises, the Federal Reserve injected additional liquidity into the financial system in the United States.

[9]The five agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the now-defunct Office of Thrift Supervision.

[10]See 75 FR 13656 (Mar. 22, 2010)

[11]The FCA has periodically amended its liquidity regulations over the past 18 years. The FCA originally adopted § 615.5134 in 1993, and subsequently amended it 1999 and 2005. See 58 FR 63056 (Nov. 30, 1993); 64 FR 28896 (May 28, 1999); 70 FR 51590 (Aug. 31, 2005). Originally, § 615.5134 required each FCS bank to maintain 15 days of liquidity, and to separately identify investments held for the purpose of meeting its liquidity reserve requirement. In 1999, the FCA repealed the provision requiring FCS banks to separately identify investments held for liquidity. In 2005, the FCA expanded the liquidity reserve requirement to 90 days, increased the limit on investments from 30 to 35 percent of total outstanding loans, and for the first time, required all FCS banks to develop CFPs for liquidity.

[12]The FCA recently proposed substantive amendments to § 615.5133. The preamble to the proposed rule discusses the FCA's expectations concerning proper investment practices at FCS banks and associations. See 76 FR 51289 (Aug. 18, 2011). The FCA incorporates by reference its guidance about proper investment management practices in the preamble to § 615.5133 into this preamble.

[13]See Interagency Policy Statement on Funding and Liquidity Risk Management, supra at 13661.

[14]Id.

[15]Id.

[16]Id.

[17]Id at 13660.

[18]See 70 FR 51587 (Aug. 31, 2005); 58 FR 63039 (Nov, 30, 1993).

[19]See Interagency Policy Statement on Funding and Liquidity Risk, 75 FR 13656, 13661 (Mar. 22, 2010).

[20]See Pub. L. 111-203, sec. 939A, 124 Stat. 1376, 1887 (Jul. 21, 2010).

[21]See 76 FR 51289, 51298 (Aug. 18, 2011) and 76 FR 53344 (Aug. 26, 2011). The first cite is to the proposed rule on investment management. The FCA is soliciting comments on how to replace NRSRO credit ratings for eligible investments. The second cite is to an Advance Notice of Proposed Rulemaking concerning the NRSRO credit ratings in our capital regulations.

[22]Basel Committee on Banking Supervision, Basel III: International framework for liquidity risk measurement, standards, and monitoring, (Dec. 2010) p. 6.

[23]Id at p. 5.

[24]Id.

[25]Id.

[26]The proposed rule on investment management would change the designation of § 615.5131(e) by omitting the paragraph designations of all definitions in the regulation.

[27]" Existing § 615.5131(e) also states, "In the money market, a security is liquid if the spread between its bid and ask price is narrow and a reasonable amount can be sold at those prices."

[28]Duration measures the price sensitivity of a fixed income security to interest rate changes.

[29]See Basel III Liquidity Framework supra. at p. 5.

[30]Id.

[31]Id.

[32]Id.

[33]Id. Market breadth refers to the price impact per unit of liquidity, whereas market depth refers to units of the asset that can be traded for a given price impact.

[34]See Interagency Policy Statement on Funding and Liquidity Risk Management, supra. at 13660.

[35]Id.

[36]Id.

[37]Obligations that are backed by the full faith credit of the United States are not eligible for the liquidity reserve if they are not marketable under proposed § 615.5134(d).

[38]A Government-sponsored agency means as an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the United States Congress but whose obligations are not explicitly insured or guaranteed by the full faith and credit of the United States Government. The FCA proposed to add this definition to § 615.5132 on August 18, 2011. See 76 FR 51289 (Aug. 18, 2011). This category would include the Federal Home Loan Banks, Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), and the Tennessee Valley Authority. Although Fannie Mae and Freddie Mac are currently in conservatorship, their obligations are not explicitly backed by the full faith and credit of the United States.

[39]Once the Government-sponsored agency senior debt securities in Level 2 come within 60 days to maturity, the bank should move them to Level 1 of the liquidity reserve so they can cover maturing obligations.

[40]See Basel III Liquidity Framework supra. at p. 21-22. The Basel Committee on Banking Supervision focused on unfunded commitments throughout Basel III.

[41]See Interagency Policy Statement on Funding and Liquidity Risk Management, supra. at 13664.

[42]Id.

[43]Id. at 13665.

[44]Id.

[45]Id.

[46]Early warning signals and event triggers encompass events that are both global and bank specific. Examples of global warning signals and event triggers include: (1) Concerns over the credit quality of particular classes of assets widely held by financial institutions; (2) widening spreads between different types of securities, or derivatives; (3) macro-economic factors adversely affecting agriculture; and (4) debt market stagnation and constrictions. Warning signals and event triggers that are specific to individual FCS banks include: (1) Draws on unfunded commitments or letters of credit; (2) a rapid and substantial increase in loan demand; (3) actual and projected increases in collateral pledged; and (4) unrealized losses in its liquidity reserve. Events such as reduced market access and the downgrading of credit ratings could be either a global or bank-specific signal or trigger.

[47]See Interagency Policy Statement on Funding and Liquidity Risk Management, supra. at 13665.

<u>List of Subjects in 12 CFR Part 615</u>

Accounting, Agriculture, Banks, banking, Government securities, Investments, Rural areas.

For the reasons stated in the preamble, part 615 of chapter VI, title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 615--FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS, AND FUNDING OPERATIONS

1. The authority citation for part 615 is revised to read as follows:

<u>Authority</u>: Secs. 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.3, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b-6, 2279aa, 2279aa-3, 2279aa-4, 2279aa-6, 2279aa-7, 2279aa-8, 2279aa-10, 2279aa-12); sec. 301(a) of Pub. L. 100-233, 101 Stat. 1568, 1608; sec. 939A of Pub. L. 111-203, 124 Stat 1326, 1887.

2. Revise § 615.5134 to read as follows:

§ 615.5134 <u>Liquidity reserve</u>.

(a) *<u>Liquidity policy.</u>*

(1) *<u>Board responsibility</u>.* The board of each Farm Credit bank must adopt a written liquidity policy. The liquidity policy must be compatible with the investment management policies that the bank's board adopts pursuant to § 615.5133 of this part. At least once every year, the bank's board must review its liquidity policy, affirmatively validate the sufficiency of its liquidity policy, and make any revisions it deems necessary. The board of each Farm Credit bank must ensure that adequate internal controls are in place so that management complies with and carries out this liquidity policy.

(2) *<u>Policy content</u>.* At a minimum, the liquidity policy of each Farm Credit bank must address:

(i) The purpose and objectives of the liquidity reserve;

(ii) Diversification requirements for the liquidity reserve portfolio;

(iii) Maturity limits and credit quality standards for investments that the bank is holding to meet the minimum liquidity reserve requirements of paragraphs (b) and (e) of this section;

(iv) The target amount of days of liquidity that the bank needs based on its business model and risk profile;

(v) The Contingency Funding Plan (CFP) required by paragraph (h) of this section;

(vi) Delegations of authority pertaining to the liquidity reserve; and

(vii) Reporting requirements, which at a minimum must require management to report to the board at least once every quarter about compliance with the bank's liquidity policy and the performance of the liquidity reserve portfolio. Management must report any deviation from the bank's liquidity policy, or failure to meet the board's liquidity targets immediately to the board.

(b) *<u>Liquidity reserve requirement</u>.* Each Farm Credit bank must maintain a liquidity reserve, in accordance with paragraph (e) of this section, sufficient to fund at least 90 days of the principal portion of maturing obligations and other borrowings of the bank at all times. Each Farm Credit bank must also maintain a supplemental liquidity buffer in accordance with paragraph (f) of this section. Each Farm Credit bank must discount the liquid assets in its liquidity reserve and its supplemental liquidity buffer in accordance with paragraph (g) of this section. The liquidity reserve must be comprised only of cash,

including cash due from traded but not yet settled debt, and qualified eligible investments under § 615.5140 of this part that are unencumbered and marketable under paragraphs (c) and (d) of this section, respectively.

(c) *Unencumbered.* All investments that a Farm Credit bank holds in its liquidity reserve in accordance with this section must be unencumbered. For the purpose of this section, an investment is unencumbered if it is free of lien, and it is not explicitly or implicitly pledged to secure, collateralize, or enhance the credit of any transaction. Additionally, an unencumbered investment held in the liquidity reserve cannot be used as a hedge against interest rate risk if liquidation of that particular investment would expose the bank to a material risk of loss.

(d) *Marketable.* All investments that a Farm Credit bank holds in its liquidity reserve in accordance with this section must be marketable. For the purposes of this section, an investment is marketable if it:

(1) Can be easily and immediately converted into cash with little or no loss in value;

(2) Exhibits low credit and market risks;

(3) Has ease and certainty of valuation; and

(4) Except for money market instruments, is listed on a developed and recognized exchange market, and can be sold or converted to cash through repurchase agreements in active and sizable markets.

(e) *Composition of liquidity reserve.* Each Farm Credit bank must continuously hold cash and the investments in the table below to meet the 90-day minimum liquidity reserve requirement in paragraph (b) of this section. A Farm Credit bank must apply the discounts in paragraph (g) of this section to all cash and investments in its liquidity reserve:

Level 1 Instruments: Each Farm Credit bank must sequentially apply Level 1 instruments to fund obligations that mature starting on day 1 through day 30. Cash and instruments with a final remaining maturity of 3 years or less must comprise at least 15 days of the liquidity reserve at Level 1.	· Cash; · Treasury securities; · Other marketable obligations that are explicitly backed by the full faith and credit of the United States; · Mortgage-backed securities issued by the Government National Mortgage Association; · Government-sponsored Agency senior debt securities that mature within 60 days, excluding senior debt securities of the Farm Credit System; and · Diversified investment Funds that are comprised exclusively of Level 1 instruments.
Level 2 Instruments: Each Farm Credit bank must sequentially apply Level 2 instruments to fund obligations that mature starting on day 31 through day 90.	· Additional amounts of Level 1 instruments; · Government-sponsored Agency senior debt securities with maturities that exceed 60 days, excluding senior debt securities of the Farm Credit System; · Government-sponsored Agency mortgage-backed securities; · Money market instruments maturing within 90 days; and · Diversified Investment Funds that are comprised exclusively of Levels 1 and 2 instruments.

(f) *Supplemental liquidity buffer*. Each Farm Credit bank must hold supplemental liquid assets in excess of the 90-day minimum liquidity reserve. The supplemental liquidity buffer must be comprised of cash and qualified eligible investments listed in § 615.5140 of this part. A Farm Credit bank must be able to liquidate any qualified eligible investment in its supplemental liquidity buffer within the liquidity policy timeframe established in the bank's liquidity policy at no less than 80 percent of its book value. A Farm Credit bank must remove from its supplemental liquidity buffer any investment that has, at any time, a market value that is less than 80 percent of its book value. The amount of supplemental liquidity that each Farm Credit bank holds, at minimum, must meet the requirements of its board's liquidity policy, provide excess liquidity beyond(5) the days covered by the liquidity reserve, and satisfy the applicable portions of the bank's CFP in accordance with paragraph (h) of this section.

(g) *Discounts.* Each Farm Credit bank must discount the liquid assets in its liquidity reserve under paragraph (d) of this section and in its supplemental liquidity buffer under paragraph (e) of this section as follows:

(1) Multiply cash and overnight investments by 100 percent.

(2) Multiply Treasury securities by 97 percent of the market value.

(3) Multiply all other Level 1 instruments by 95 percent of their market value, even if the bank holds them in Level 2 to fund obligations maturing starting on day 31 through day 90.

(4) Multiply all Level 2 instruments by 93 percent of the market value.

(5) Multiply all other qualified investments held for meeting the bank's liquidity policy and contingency plans by 85 percent of market value unless they merit Level 1 or Level 2 instrument discounts.

(h) *Contingency Funding Plan (CFP).* The board of each Farm Credit bank must adopt a CFP to ensure sources of liquidity are sufficient to fund normal operations under a variety of stress events including market disruptions, rapid increase in loan demand, unexpected draws on unfunded commitments, difficulties in renewing or replacing funding with desired terms and structures, requirements to pledge collateral with counterparties, and reduced market access. Each Farm Credit bank must maintain an adequate level of unencumbered and marketable assets in its liquidity reserve that can be converted into cash to meet its net liquidity needs based on estimated cash inflows and outflows for a 30-day time horizon under an acute stress scenario. The board of directors must review and approve the CFP at least once every year and make adjustments to reflect changes in the bank's risk profile and market conditions. The CFP must:

(1) Be customized to the financial condition and liquidity risk profile of the bank and the board's liquidity risk tolerance policy.

(2) Identify funding alternatives that the Farm Credit bank can implement whenever access to funding is impeded, which must include, at a minimum, arrangements for pledging collateral to secure funding and possible initiatives to raise additional capital.

(3) Require periodic stress testing, which analyzes the possible impacts on the bank's cash inflows and outflows, liquidity position, profitability and solvency under a variety of stress scenarios.

(4) Establish a process for managing events that imperil the bank's liquidity, and assign appropriate personnel and implement executable action plans that carry out the CFP.

(i) *Reservation of Authority.* The Farm Credit Administration reserves the right to require a Farm Credit bank to adjust the treatment of assets in its liquidity reserve so that it has liquidity that is sufficient and commensurate for the risks it faces. The Farm Credit Administration reserves the right to use this authority in response to adverse financial, economic, or market conditions by requiring any Farm Credit bank, on a case-by-case basis, to:

(1) Apply a greater discount to any individual security or any class of securities;

(2) Shift individual or multiple securities from one level of the liquidity reserve to another, or between one of the levels of the liquidity reserve and the supplemental liquidity buffer based on the performance of such asset(s), or based on financial, economic, or market conditions affecting the liquidity and solvency of the bank;

(3) Spread out or otherwise change concentrations in the allocation of securities in any level of the bank's liquidity reserve and its supplemental liquidity buffer;

(4) Perform additional stress tests using other or different stress criteria or scenarios;

(5) Hold additional liquid assets to cover unfunded commitments and other contingent outflows; or

(6) Take any other action that the Farm Credit Administration deems necessary to ensure that the bank has sufficient liquidity to meet its financial obligations as they fall due.

Date: December 15, 2011

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.

76 FR 27564, 05/11/2011

Handbook Mailing HM-11-3

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 45
Docket No. OCC-2011-0008
RIN: 1557-AD43

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
12 CFR Part 237
Docket No. R-1415
RIN: 7100 AD74

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 324
RIN: 3064-AD79

FARM CREDIT ADMINISTRATION
12 CFR Part 624
RIN: 3052-AC69

FEDERAL HOUSING FINANCE AGENCY
12 CFR Part 1221
RIN: 2590-AA45

MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Farm Credit Administration (FCA); and the Federal Housing Finance Agency (FHFA).

ACTION: Notice of proposed rulemaking.

SUMMARY: The OCC, Board, FDIC, FCA, and FHFA (collectively, the Agencies) are requesting comment on a proposal to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the Agencies is the prudential regulator. This proposed rule implements sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which require the Agencies to adopt rules jointly to establish capital requirements and initial and variation margin requirements for such entities on all non-cleared swaps and non-cleared security-based swaps in order to offset the greater risk to such entities and the financial system arising from the use of swaps and security-based swaps that are not cleared.

DATES: Comments should be received on or before June 24, 2011.

ADDRESSES: Interested parties are encouraged to submit written comments jointly to all of the Agencies. Commenters are encouraged to use the title "Margin and Capital Requirements for Covered Swap Entities" to facilitate the organization and distribution of comments among the Agencies. Commenters are also encouraged to identify the number of the specific question for comment to which they are responding.

Office of the Comptroller of the Currency: Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or e-mail, if possible. Please use the title "Margin and Capital Requirements" to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- **Federal eRulemaking Portal – "Regulations.gov":** Go to http://www.regulations.gov. Select "Document Type" of "Proposed Rules," and in the "Enter Keyword or ID Box," enter Docket ID "OCC-2011-0008," and click "Search." On "View By Relevance" tab at the bottom of screen, in the "Agency" column, locate the Proposed Rule for the OCC, in the "Action" column, click on "Submit a Comment" or "Open Docket Folder" to submit or view public comments and to view supporting and related materials for this rulemaking action.
- Click on the "Help" tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.
- **E-mail:** regs.comments@occ.treas.gov.
- **Mail:** Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.
- **Fax:** (202) 874-5274.
- **Hand Delivery/Courier:** 250 E Street, SW., Mail Stop 2-3, Washington, DC 20219.

Instructions : You must include "OCC" as the agency name and "Docket ID OCC-2011-0008" in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this proposed rulemaking by any of the following methods:

- **Viewing Comments Electronically:** Go to http://www.regulations.gov. Select "Document Type" of "Public Submissions," and in the "Enter Keyword or ID Box," enter Docket ID "OCC-2011-0008," and click "Search." Comments will be listed under "View By Relevance" tab at the bottom of screen. If comments from more than one agency are listed, the "Agency" column will indicate which comments were received by the OCC.
- **Viewing Comments Personally:** You may personally inspect and photocopy comments at the OCC, 250 E Street, SW., Washington, DC. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.
- **Docket:** You may also view or request available background documents and project

summaries using the methods described above.

Board of Governors of the Federal Reserve System: You may submit comments, identified by Docket No. R-1415 and RIN 7100 AD74, by any of the following methods:

- **Agency Web Site**: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- **Federal eRulemaking Portal**: http://www.regulations.gov. Follow the instructions for submitting comments.
- **E-mail**: regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.
- **Fax**: (202) 452-3819 or (202) 452-3102.
- Mail: Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments will be made available on the Board's web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

Federal Deposit Insurance Corporation: You may submit comments, identified by RIN number, by any of the following methods:

- **Agency Web Site:** http://www.fdic.gov/regulations/laws/federal/propose.html. Follow instructions for submitting comments on the Agency Web Site.
- **E-mail:** Comments@FDIC.gov. Include the RIN number on the subject line of the message.
- **Mail:** Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- **Hand Delivery:** Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m.

Instructions: All comments received must include the agency name and RIN for this rulemaking and will be posted without change to http://www.fdic.gov/regulations/laws/ federal/propose.html, including any personal information provided.

Federal Housing Finance Agency: You may submit your written comments on the proposed rulemaking, identified by regulatory information number (RIN) 2590-AA45, by any of the following methods:

- **E-mail**: Comments to Alfred M. Pollard, General Counsel, may be sent by e-mail at RegComments@fhfa.gov. Please include "RIN 2590-AA45" in the subject line of the message.
- **Federal eRulemaking Portal:** http://www.regulations.gov. Follow the instructions for submitting comments. If you submit your comment to the Federal eRulemaking Portal, please also send it by e-mail to FHFA at RegComments@fhfa.gov to ensure timely receipt by the Agency. Please include ''RIN 2590-AA45" in the subject line of the message.
- **U.S. Mail, United Parcel Service, Federal Express, or Other Mail Service**: The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/ RIN 2590-AA45, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.
- **Hand Delivery/Courier**: The hand delivery address is: Alfred M. Pollard, General Counsel,

Attention: Comments/ RIN 2590-AA45, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. A hand-delivered package should be logged at the Guard Desk, First Floor, on business days between 9:00 a.m. and 5:00 p.m.

All comments received by the deadline will be posted for public inspection without change, including any personal information you provide, such as your name and address, on the FHFA website at http://www.fhfa.gov. Copies of all comments timely received will be available for public inspection and copying at the address above on government-business days between the hours of 10 a.m. and 3 p.m. To make an appointment to inspect comments please call the Office of General Counsel at (202) 414-6924.

Farm Credit Administration: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comments multiple times via different methods. You may submit comments by any of the following methods:

- **E-mail:** Send us an e-mail at reg-comm@fca.gov.
- **FCA Web site**: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- **Federal eRulemaking Portal:** http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Gary K. Van Meter, Acting Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

OCC: Michael Sullivan, Market RAD (202) 874-3978, Kurt Wilhelm, Director, Financial Markets Group (202) 874-4479, Jamey Basham, Assistant Director, Legislative and Regulatory Activities Division (202) 874-5090, or Ron Shimabukuro, Senior Counsel, Legislative and Regulatory Activities Division (202) 874-5090, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

Board: Sean D. Campbell, Deputy Associate Director, Division of Research and Statistics, (202) 452-3761, Michael Gibson, Senior Associate Director, Division of Research and Statistics, (202) 452-2495, or Jeremy R. Newell, Senior Attorney, Legal Division, (202) 452-3239, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington , D.C. 20551.

FDIC: Bobby R. Bean, Chief, Policy Section, (202) 898-6705, John Feid, Senior Capital Markets Specialist, (202) 898-8649, Division of Risk Management Supervision, Thomas F. Hearn, Counsel, (202) 898-6967, or Ryan K. Clougherty, Senior Attorney, (202) 898-3843, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

FHFA: Robert Collender, Principal Policy Analyst, Office of Policy Analysis and Research, 202-343-1510, Robert.Collender@fhfa.gov, Peggy Balsawer, Assistant General Counsel, Office of General Counsel, 202-343-1529, Peggy.Balsawer@fhfa.gov. or James Carley, Senior Associate Director, Division of FHLBank Regulation, 202.408.2507, james.carley@fhfa.gov, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877-8339.

FCA: William G. Dunn, Acting Associate Director, Finance and Capital Markets Team, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434, Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4434, or Rebecca S. Orlich, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Background.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was enacted on July 21, 2010.[1] Title VII of the Dodd-Frank Act established a comprehensive new regulatory framework for derivatives, which the Act generally characterizes as "swaps" (which are defined in section 721 of the Dodd-Frank Act to include interest rate swaps, commodity-based swaps, and broad-based credit swaps) and "security-based swaps" (which are defined in section 761 of the Dodd-Frank Act to include single-name and narrow-based credit swaps and equity-based swaps).[2]

As part of this new regulatory framework, sections 731 and 764 of the Dodd-Frank Act add a new section 4s to the Commodity Exchange Act and a new section 15F to the Securities Exchange Act of 1934, respectively, which require the registration and regulation of swap dealers and major swap participants and security-based swap dealers and major security-based swap participants (collectively, swap entities).[3] For certain types of swap entities that are prudentially regulated by one of the Agencies,[4] sections 731 and 764 of the Dodd-Frank Act require the Agencies to adopt rules jointly for swap entities under their respective jurisdictions imposing (i) capital requirements and (ii) initial and variation margin requirements on all non-cleared swaps and non-cleared security-based swaps.[5] Swap entities that are prudentially regulated by the Agencies and therefore subject to the proposed rule are referred to herein as "covered swap entities."

Sections 731 and 764 of the Dodd-Frank Act require the CFTC and SEC to separately adopt rules imposing capital and margin requirements for swap entities for which there is no prudential regulator.[6] The Dodd-Frank Act requires the CFTC, SEC, and the Agencies to establish and maintain, to the maximum extent practicable, capital and margin requirements that are comparable, and to consult with each other periodically (but no less than annually) regarding these requirements.[7]

The capital and margin standards for swap entities imposed under sections 731 and 764 of the Dodd-Frank Act are intended to offset the greater risk to the swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared.[8] Sections 731 and 764 of the Dodd-Frank Act require that the capital and margin requirements imposed on swap entities must, to offset such risk, (i) help ensure the safety and soundness of the swap entity and (ii) be appropriate for the greater risk associated with the non-cleared swaps and non-cleared security-based swaps held as a swap entity.[9] In addition, Sections 731 and 764 of the Dodd-Frank Act require the Agencies, in establishing capital

rules for covered swap entities, to take into account the risks associated with other types, classes or categories of swaps or security-based swaps engaged in, and the other activities conducted by that person that are not otherwise subject to regulation applicable to that person by virtue of the status of the person as a swap dealer or a major swap participant.[10] Sections 731 and 764 become effective not less than 60 days after publication of the final rule or regulation implementing these sections.[11]

The capital and margin requirements that must be established with respect to non-cleared derivatives under sections 731 and 764 of the Dodd-Frank Act complement changes made elsewhere in the Act that require all sufficiently standardized swaps and security-based swaps be cleared through a derivatives clearing organization or clearing agency.[12] This clearing mandate reflects the consensus of the G-20 leaders: "All standardized over-the-counter derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end of 2012 at the latest."[13]
In the derivatives clearing process, central counterparties (CCPs) manage the credit risk through a range of controls and methods, including a margining regime that imposes both initial margin and variation margin requirements on parties to cleared transactions.[14] Thus, the mandatory clearing requirement established by the Dodd-Frank Act for swaps and security-based swaps will effectively require any party to any transaction subject to the clearing mandate to post initial and variation margin to the CCP in connection with that transaction.

However, if a particular swap or security-based swap is not cleared because it is not subject to the mandatory clearing requirement (or because one of the parties to a particular swap or security-based swap is eligible for, and uses, an exemption from the mandatory clearing requirement), that swap or security-based swap will be a "non-cleared" swap or security-based swap and will be subject to the capital and margin requirements for such transactions established under sections 731 and 764 of the Dodd-Frank Act.

The comprehensive derivatives-related provisions of title VII of the Dodd-Frank Act, including sections 731 and 764, are intended in general to reduce risk, increase transparency, promote market integrity within the financial system, and, in particular, address a number of weaknesses in the regulation and structure of the derivatives markets that were revealed during the financial crisis experienced in 2008 and 2009. During the financial crisis, the opacity of derivatives transactions among dealer banks and between dealer banks and their counterparties created uncertainty about whether market participants were significantly exposed to the risk of a default by a swap counterparty. By imposing a regulatory margin requirement on non-cleared swaps, the Dodd-Frank Act will reduce the uncertainty around the possible exposures arising from non-cleared swaps.

The recent financial crisis also revealed that some participants in the derivatives markets had used derivatives to take on excessive risks. By imposing a minimum margin requirement on non-cleared derivatives, sections 731 and 764 of the Dodd-Frank Act will reduce the ability of firms to take on excessive risks through swaps without sufficient financial resources to make good on their contracts. Because the Dodd-Frank Act requires that the margin requirements be based on the risks posed by the non-cleared derivatives and derivatives counterparties, firms that take significant risks through derivatives will face more stringent margin requirements with respect to non-cleared derivatives, while firms that take lower risks will face less stringent margin requirements.

II. Overview of Proposed Rule.

A. Margin Requirements

The Agencies have generally adopted a risk-based approach in proposing rules to establish initial and variation margin requirements for covered swap entities, consistent with the statutory requirement that these rules help ensure the safety and soundness of the covered swap entity and be appropriate for the risk to the financial system associated with non-cleared swaps and non-cleared security-based swaps held by covered swap entities. As a result, the proposed rule takes into account the relative risk of a covered swap entity's activities in establishing both (i) the minimum amount of initial and variation margin that it must collect from its counterparties and (ii) the frequency with which a covered swap entity must calculate and collect variation margin from its counterparty.

In implementing this risk-based approach, the proposed rule distinguishes among four separate types of derivatives counterparties: (i) counterparties that are themselves swap entities; (ii) counterparties that are high-risk financial end users of derivatives; (iii) counterparties that are low-risk financial end users of derivatives; and (iv) counterparties that are nonfinancial end users of derivatives.[15] These categories reflect the Agencies' preliminary belief that distinctions can be made between types of derivatives counterparties that are useful in distinguishing the risks posed by each type.

The proposed rule's initial and variation margin requirements generally apply only to the collection of minimum margin amounts by a covered swap entity from its counterparties; they do not contain specific requirements as to the amount of initial or variation margin that a covered swap entity must post to its counterparties.[16] This approach, which emphasizes the collection rather than the posting of margin, is based primarily on the Agencies' preliminary view that imposing requirements with respect to the minimum amount of margin to be collected (but not posted) is a critical aspect of offsetting the greater risk to the covered swap entity and the financial system arising from the covered swap entity's holdings of swaps and security-based swaps that are not cleared and helps ensure the safety and soundness of the covered swap entity. The proposed rule's approach would also assure that swap entities transacting with one another will effectively be collecting and posting margin with respect to those transactions as a result of the margin collection requirements imposed on each.
With respect to initial margin, the proposed rule permits a covered swap entity to select from two alternatives to calculate its initial margin requirements. A covered swap entity may calculate its initial margin requirements using a standardized "lookup" table that specifies the minimum initial margin that must be collected, expressed as a percentage of the notional amount of the swap or security-based swap. These percentages depend on the broad asset class of the swap or security-based swap.[17] Alternatively, a covered swap entity may calculate its minimum initial margin requirements using an internal margin model that meets certain criteria and that has been approved by the relevant prudential regulator.[18]

A covered swap entity adopting the first alternative generally must collect at least the amount of initial margin required under the standardized look-up table, regardless of the relative risk of its counterparty. A covered swap entity adopting the second alternative generally must collect at least the amount of initial margin required under its initial margin model. Both alternatives permit a covered swap entity to adopt a threshold amount below which it need not collect initial margin from certain types of counterparties.[19] Under the proposed rule, the maximum threshold amount permitted varies based on the relative risk posed by the counterparty, as determined by counterparty type.

With respect to variation margin, the proposed rule generally requires a covered swap entity to collect variation margin periodically in an amount that is at least equal to the increase in the value of the swap to the covered swap entity.[20] As with initial margin, a covered swap entity may adopt a threshold amount below which it need not collect variation margin from certain types of lower-risk counterparties.[21] Consistent with the approach taken to initial margin, the maximum threshold amount permitted for

variation margin varies based on the relative risk of the counterparty, as determined by counterparty type. In addition, the frequency with which a covered swap entity must periodically recalculate and collect variation margin under the proposed rule also varies based on the relative risk of the counterparty, as determined by counterparty type, and generally decreases as the relative risk of the counterparty type decreases.[22]

The proposed rule's margin provisions establish only minimum requirements with respect to initial margin and variation that must be collected. Nothing in the proposed rule is intended to prevent or discourage a covered swap entity from collecting margin in amounts greater than is required under the proposed rule.

The proposed rule also specifies the types of collateral that are eligible to be collected to satisfy both the initial and variation margin requirements. Eligible collateral is generally limited to (i) immediately-available cash funds and (ii) certain high-quality, highly-liquid U.S. government and agency obligations and, in the case of initial margin only, certain government-sponsored enterprise obligations, subject to specified minimum "haircuts" for purposes of determining their value for margin purposes.[23]

Separate from the proposed rule's requirements with respect to the collection of initial and variation margin, the proposed rule also requires a covered swap entity to ensure that its counterparty segregates the initial margin that the covered swap entity posts when engaging in swap or security-based swap transactions with another swap entity.[24] The Agencies have proposed a requirement that segregation of initial margin be mandatory, not optional, for swap transactions by a covered swap entity with another swap entity in order to (i) offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and (ii) protect the safety and soundness of the covered swap entity.

B. Capital Requirements

Sections 731 and 764 of the Dodd-Frank Act also require the Agencies to issue, in addition to margin rules, joint rules on capital for covered swap entities for which they are the prudential regulator.[25] The Board, FDIC, and OCC (collectively, the banking agencies) have had risk-based capital rules in place for banks to address over-the-counter derivatives since 1989 when the banking agencies implemented their risk-based capital adequacy standards (general banking risk-based capital rules)[26] based on the first Basel Accord.[27] The general banking risk-based capital rules have been amended and supplemented over time to take into account developments in the derivatives market. These supplements include the addition of the market risk amendment to the first Basel Accord which requires banks and bank holding companies meeting certain thresholds to calculate their capital requirements for trading positions through models approved by their primary Federal supervisor.[28] In addition, certain large, complex banks and bank holding companies are subject to the banking agencies' advanced risk-based capital standards (advanced approaches rules), based on the advanced approaches of the Basel II Accord.[29]

FHFA's predecessor agencies used a similar methodology to frame the risk-based capital rules applicable to those entities now regulated by FHFA. The FCA's risk-based capital regulations for Farm Credit System institutions, except for the Federal Agricultural Mortgage Corporation (Farmer Mac), have been in place since 1988 and were updated in 2005.[30] The FCA's risk-based capital regulations for Farmer Mac have been in place since 2001 and were updated in 2006.[31]

The Basel Committee on Banking Supervision has recently revised and enhanced its capital

framework for internationally active banks,[32] and the banking agencies expect to propose these changes in the United States in the near future through a separate notice of proposed rulemaking.

As described in section III.J below, the proposed rule requires a covered swap entity to comply with regulatory capital rules already made applicable to that covered swap entity as part of its prudential regulatory regime**.** As discussed further below, given that these existing regulatory capital rules already specifically take into account and address the unique risks arising from derivatives transactions and activities, the Agencies are proposing to rely on these existing rules, subject to the future notice of proposed rulemaking described above, as appropriate and sufficient to offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and to protect the safety and soundness of the covered swap entity.[33]

III. Section by Section Summary of Proposed Rule.

A. Section __.1: Authority, Purpose and Scope

Section __.1 of the proposed rule specifies the scope of swap and security-based swap transactions to which the margin requirements apply. It provides that the margin requirements apply to all non-cleared swaps and security-based swaps into which a covered swap entity enters, regardless of the type of transaction or the nature of the counterparty. It also provides that the margin requirements apply only to swap and security-based swap transactions that are entered into on or after the date on which the proposed rule becomes effective.

1. Treatment of Pre-Effective Date Derivatives

The Agencies note that it is possible that a covered swap entity may enter into swap or security-based swap transactions on or after the proposed rule's effective date pursuant to the same master netting agreement with a counterparty that governs existing swaps or security-based swaps entered into prior to the effective date. As discussed below, the proposed rules permit a covered swap entity to (i) calculate initial margin requirements for swaps and security-based swaps under a qualifying master netting agreement with the counterparty on a portfolio basis in certain circumstances, if it is using an initial margin model to do so, and (ii) calculate variation margin requirements under the proposed rule on an aggregate, net basis under a qualifying master netting agreement with the counterparty. Applying the new margin rules in such a way would, in some cases, have the effect of applying the margin rules retroactively to pre-effective-date swaps under the master agreement. Accordingly, in the case of initial margin, a covered swap entity using an initial margin model would be permitted, at its option, to calculate the initial margin requirements on a portfolio basis but include only post-effective-date derivatives in the relevant portfolio.[34] With respect to variation margin, the Agencies expect that the covered swap entity will comply with the margin requirements with respect to all swaps and security-based swaps governed by a master agreement, regardless of the date on which they were entered into, consistent with current industry practice. The Agencies request comment on (i) what, if any, practical difficulties might be raised by the proposed approach to application of the margin requirements under master agreements governing both pre- and post-effective-date swaps and security-based swaps and (ii) whether there are alternative approaches that might better address the issues raised by such master agreements.

2. Treatment of Derivatives with Commercial End User Counterparties

Following passage of the Dodd-Frank Act, various observers expressed concerns regarding whether sections 731 and 764 of the Dodd-Frank Act authorize or require the CFTC, SEC, and Agencies to establish margin requirements with respect to transactions between a covered swap entity and a

"commercial end user" (i.e., a nonfinancial counterparty that engages in derivatives activities to hedge commercial risk),[35] and have argued that swaps and security-based swap transactions with these types of counterparties should be excluded from the scope of margin requirements imposed under sections 731 and 764 because commercial firms engaged in hedging activities pose a reduced risk to their counterparties and the stability of the U.S. financial system. In addition, statements in the legislative history of sections 731 and 764 suggest that Congress did not intend, in enacting these sections, to impose margin requirements on nonfinancial end users engaged in hedging activities, even in cases where they entered into swaps or security-based swaps with swap entities.[36]

In formulating the proposed rule, the Agencies have carefully considered these concerns and statements. The plain language of sections 731 and 764 provides that the Agencies adopt rules for covered swap entities imposing margin requirements on all non-cleared swaps. Those sections do not, by their terms, exclude a swap with a counterparty that is a commercial end user.

Importantly, those sections also provide that the Agencies adopt margin requirements that (i) help ensure the safety and soundness of the covered swap entity and (ii) are appropriate for the risk associated with the non-cleared swaps and non-cleared security-based swaps it holds as a swap entity. Thus, the statute requires the Agencies to take a risk-based approach to establishing margin requirements.

The proposed rule follows this statutory framework and proposes a risk-based approach to imposing margin requirements in which nonfinancial end users are categorized as lower-risk counterparties than financial end users. In particular, the proposed rule permits covered swap entities to adopt, where appropriate, initial and variation margin thresholds below which a covered swap entity is not required to collect initial and/or variation margin from counterparties that are end users because of the lesser risk posed by these types of counterparties to covered swap entities and financial stability with respect to exposures below these thresholds. The Agencies note that this threshold-based approach is consistent with current market practices with respect to nonfinancial end users, in which derivatives dealers view the question of whether and to what extent to require margin from their counterparties as a credit decision.[37]

Under the proposed rule, a covered swap entity would not be required to collect initial or variation margin from a nonfinancial end user counterparty as long as the covered swap entity's exposures to the nonfinancial end user were below the credit exposure limits that the covered swap entity has established under appropriate credit processes and standards. The Agencies preliminarily believe that this approach is consistent with the statutory requirement that the margin requirements be risk-based, and is appropriate in light of the minimal risks that nonfinancial end users pose to the safety and soundness of covered swap entities and U.S. financial stability, particularly in cases of relatively small margin exposures.

To the extent that a covered swap entity has adopted an initial margin threshold amount or a variation margin threshold amount for a nonfinancial end user counterparty but the cumulative required initial margin or variation margin, respectively, for transactions with that end user exceeds the initial margin threshold amount or variation margin threshold amount, respectively, the covered swap entity would be required to collect the excess amount. The Agencies preliminarily believe that this approach is appropriate for the greater risk posed by such counterparties where margin exposures are relatively large.

The Agencies request comment on the appropriateness of the proposed rule's approach to a covered swap entity's transactions with nonfinancial end users and whether there are alternative approaches that would better achieve the objective of sections 731 and 764 of the Dodd-Frank Act. In particular, the Agencies note that under other provisions of the Dodd-Frank Act, nonfinancial end users

that engage in derivatives to hedge their commercial risks are exempt from the requirement that all designated swaps and security-based swaps be cleared by a derivatives clearing organization or clearing agency, respectively. A major consequence of clearing a swap or security-based swap is a requirement that each party to the transaction post initial margin and variation margin to the derivatives clearing organization or clearing agency, and the exemption from the clearing requirement permits a nonfinancial end user taking advantage of the exemption to avoid posting margin to such central CCPs. Although the Dodd-Frank Act does not contain an express exemption from the margin requirement of sections 731 and 764 of the Dodd-Frank Act that is similar to the exemption for commercial end users from the mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act, the Agencies note that the proposed rule's approach to margin requirements for derivatives with nonfinancial end users could be viewed as lessening the effectiveness of the clearing requirement exemption for these nonfinancial end users as concerns margin.

In particular, the Agencies request comment on the following questions:

Question 1(a). Does the nonfinancial end user exemption from the mandatory clearing requirement suggest or require that swaps and security-based swaps involving a nonfinancial end user should or must be exempt from initial margin and variation margin requirements for non-cleared swaps and security-based swaps? 1(b) If so, upon what statutory basis would such an exemption rely? 1(c) Should that determination vary based on whether a particular non-cleared swap or non-cleared security-based swap is subject to the mandatory clearing regime or not (i.e., whether the nonfinancial end user is actually using the clearing exemption)?

Question 2. Should counterparties that are small financial institutions using derivatives to hedge their risks be treated in the same manner as nonfinancial end users for purposes of the margin requirements?

3. Effective Date

Section __.1 of the proposed rule provides that the proposed rule shall be effective with respect to any swap or security-based swap to which a covered swap entity becomes a party on or after the date that is 180 days following publication of the final rule in the Federal Register. The Agencies request comment regarding the appropriateness of this 180-day period.

The Agencies expect that covered swap entities are likely to need to make a number of changes to their current derivatives business operations in order to achieve compliance with the proposed rules, including potential changes to internal risk management and other systems, trading documentation, collateral arrangements, and operational technology and infrastructure. In addition, the Agencies expect that covered swap entities that wish to calculate initial margin using an initial margin model will need sufficient time to develop such models and obtain regulatory approval for their use. The Agencies request comment on the following implementation questions:

Question 3(a). What changes to internal risk management and other systems, trading documentation, collateral arrangements, operational technology and infrastructure or other aspects of a covered swap entity's derivatives operations will likely need to be made as part of the implementation of the proposed rule, and how much time will likely be required to make such changes? 3(b) Is the proposed rule's 180-day period sufficient?

Question 4(a). How much time will covered swap entities that wish to calculate initial margin using an initial margin model need to develop such models? 4(b) Is the proposed rule's 180-day period sufficient?

B. Section __.2: Definitions

Section __.2 of the proposed rule provides definitions of the key terms used in the proposed rule. In particular, § __.2 (i) defines the four types of swap and security-based swap counterparties that form the basis of the proposed rule's risk-based approach to margin requirements and (ii) provides other key operative terms that are needed to calculate the amount of initial and variation margin required under other sections of the proposed rule.

1. Counterparty Definitions.

The four types of counterparties defined in the proposed rule are (in order of highest to lowest risk): (i) swap entities; (ii) high-risk financial end users; (iii) low-risk financial end users; and (iv) nonfinancial end users.

a. "Swap entities."

The proposed rule defines "swap entity" as any entity that is required to register as a swap dealer, major swap participant, security-based swap dealer or major security-based swap participant.[38] Non-cleared swaps transactions with counterparties that are themselves swap entities pose risk to the financial system because swap entities are large players in swap and security-based swap markets and therefore have the potential to generate systemic risk through their swap activities. Because of their interconnectedness and large presence in the market, the failure of a single swap entity could cause severe stress throughout the financial system.[39]

Accordingly, it is the preliminary view of the Agencies that all non-cleared swap transactions with swap entities should require margin.

b. "Financial end users" and "nonfinancial end users."

Non-cleared swap transactions with end users (i.e., those counterparties that are not themselves swap entities) can also pose risks to covered swap entities. Among end users, financial end users are considered more risky than nonfinancial end users because the profitability and viability of financial end users is more tightly linked to the health of the financial system than nonfinancial end users. Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the covered swap entity. Section __.2 of the proposed rule defines a financial end user as any counterparty, other than a swap entity, that is: (i) a commodity pool (as defined in section 1a(5) of the Commodity Exchange Act (7 U.S.C. 1a(5))); (ii) a private fund (as defined in section 202(a) of the Investment Advisors Act of 1940 (15 U.S.C. 80-b-2(a))); (iii) an employee benefit plan (as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002)); (iv) a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company of 1956 (12 U.S.C. 1843(k))[40]; (v) a person that would be a commodity pool or private fund if it were organized under the laws of the United States or any State thereof; and (vi) any other person that one of the Agencies may designate with respect to covered swap entities for which it is the prudential regulator.[41]

The proposed definition of a counterparty that is a financial end user also includes any government of any foreign country or any political subdivision, agency, or instrumentality thereof.[42] The Agencies note that these types of sovereign counterparties do not fit easily into the proposed rule's categories of financial and nonfinancial end users. In comparing the characteristics of sovereign

counterparties with those of financial and nonfinancial end users, the Agencies preliminarily believe that the financial condition of a sovereign will tend to be closely linked with the financial condition of its domestic banking system, through common effects of the business cycle on both government finances and bank losses, as well as through the safety net that many sovereigns provide to banks. Such a tight link with the health of its domestic banking system, and by extension with the broader global financial system, makes a sovereign counterparty similar to a financial end user both in the nature of the systemic risk and the risk to the safety and soundness of the covered swap entity. As a result, the Agencies propose to treat sovereign counterparties as financial end users for purposes of the proposed rule's margin requirements.

The proposed rule defines a nonfinancial end user as any counterparty that is an end user but is not a financial end user.

c. "High-risk financial end user" and "low-risk financial end user."

A financial end user counterparty whose derivatives activities are relatively limited and pose little or no risk is classified as a low-risk financial end user; other end user counterparties are classified as high-risk financial end users. The likelihood of a financial end user counterparty's failure with respect to a covered swap entity during stressed market conditions increases with, among other things, the size and riskiness of its derivatives activity, and the potential impact to the covered swap entity's safety and soundness increases with the size of its non-cleared swaps exposure to the end user counterparty. Accordingly, the proposed rule is structured so that a covered swap entity would generally be required to reduce its counterparty exposure through more stringent margin collection requirements with respect to non-cleared derivatives with financial end user counterparties having greater and riskier derivatives activities.

Section __.2 of the proposed rule deems a financial end user counterparty to be a low-risk financial end user only if it meets all of the following three criteria:

- Its swaps or security-based swaps fall below a specified "significant swaps exposure" threshold;
- It predominantly uses swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate, or other risk arising from the business of the counterparty; and
- It is subject to capital requirements established by a prudential regulator or state insurance regulator.[43]

With respect to the first criterion, the definition of "significant swaps exposure" under the proposed rule is very similar to the definition of "substantial counterparty exposure" proposed by the CFTC and SEC for purposes of establishing what level of swap and security-based swap counterparty exposure would require a person to register as a major swap participant or major security-based swap participant under the Commodity Exchange Act or the Securities Exchange Act, respectively, except that the threshold amounts are established at half the level that would require registration as a major swap participant or major security-based swap participant.[44] The proposed rule's definition is thus intended to capture persons that, while not having derivatives positions rising to the level requiring margin requirements and comprehensive regulation as a major swap participant, nonetheless have substantial activity in the market and are more likely to pose greater risk to covered swap entities with which they transact than persons with only minor activity in the market. The Agencies request comment on whether this definition of significant swaps exposure is appropriate, or whether an alternative threshold amount or definition would be more consistent with the purposes of sections 731 and 764 of the Dodd-Frank Act.

The second criterion of the proposed definition of a low-risk financial end user references the purpose for which the financial end user enters into swaps or security-based swaps. This criterion generally mirrors the description of hedging-related swaps and security-based swaps that are excluded for purposes of determining whether a person maintains a substantial position in swaps or security-based swaps and therefore meets the definition of a major swap participant or major security-based swap participant under the Commodity Exchange Act and Securities Exchange Act, respectively.[45] This distinction reflects the fact that persons using derivatives predominantly to hedge or mitigate risks arising from their business, rather than to speculate for profit, are likely to pose less risk to the covered swap entity (e.g., because losses on a hedging-related swap will usually be accompanied by offsetting gains on the related position that it hedges).

The third criterion of the proposed definition of low-risk financial end user references whether the financial end user is subject to regulatory capital requirements. This criterion also generally mirrors the description of certain financial companies that are excluded from one prong of the definition of a major swap participant or major security-based swap participant under the Commodity Exchange Act and the Securities Exchange Act, respectively.[46] This distinction reflects the fact that financial end users that are subject to regulatory capital requirements are likely to pose less risk as counterparties (e.g., because the requirements ensure that minimum amounts of capital will be available to absorb any losses on their derivatives transactions).

The Agencies request comment on whether the proposed rule's categorization of various types of counterparties by risk, and the key definitions used to implement this risk-based approach, are appropriate, or whether alternative approaches or definitions would better reflect the purposes of sections 731 and 764 of the Dodd-Frank Act.

Question 5. Do the definitions adequately identify financial end user counterparties that are high-risk and low-risk?

Question 6(a). Should nonfinancial end users also be separated into high-risk and low-risk categories for purposes of the margin requirements? 6(b) If so, on what basis (e.g., in a manner similar to the classification of high-risk and low-risk financial end users)? 6(c) If so, how should the margin requirement apply differently to such high-risk and low-risk nonfinancial end users?

Question 7(a). Is the classification of sovereign counterparties as financial end users appropriate in light of the risks posed by these counterparties? 7(b) If not, what other classification would be appropriate, and why?

Question 8(a). Should sovereign counterparties receive their own distinct counterparty classification that is different from those classifications in the proposed rule? 8(b) If so, why? 8(c) How should the permitted uncollateralized exposures to a sovereign counterparty differ from those that are allowed for financial or nonfinancial end users?

Question 9. Is it appropriate to distinguish between financial and non-financial counterparties for the purpose of this risk-based approach?

Question 10. What other factors or tests should be used to determine the relative risk of an end user counterparty?

Question 11(a). Does the proposed rule require greater clarity with respect to the treatment of U.S. federal, state, or municipal government counterparties? 11(b) If so, how should such counterparties be

treated?

Question 12. Should a counterparty that is a bank holding company or nonbank financial firm subject to enhanced prudential standards under Section 165 of the Dodd-Frank Act be treated similarly to swap entity counterparties?

The Agencies also request comment on the other definitions included in the proposed rule, including those discussed in further detail below.

C. Section __.3: Initial Margin

Section __.3 of the proposed rules specifies the manner in which a covered swap entity must calculate the initial margin requirement applicable to its swaps and security-based swaps. These initial margin requirements apply only to the amount of initial margin that a covered swap entity is required to collect from its counterparties; they do not address whether, or in what amounts, a covered swap entity must post initial margin to a derivatives counterparty. Except as described below in the summary of § __.6 of the proposed rule, the posting of initial margin by a covered swap entity to a counterparty is generally left to the mutual agreement of the covered swap entity and its counterparty. In the case where a covered swap entity enters into a swap with a counterparty that itself is a swap entity, its counterparty is likely to be subject to a regulatory margin requirement under section 731 or section 764 requiring it to collect margin from its counterparties. Thus, both parties to a non-cleared swap between two swap entities will have to collect and post margin as required by the SEC, CFTC or their prudential regulator, as applicable.[47]

1. Calculation Alternatives.

The proposed rule permits a covered swap entity to select from two alternatives for calculating its initial margin requirements. In all cases, the initial margin amount required under the proposed rule is a minimum requirement; covered swap entities are not precluded from collecting additional initial margin (whether by contract or subsequent agreement with the counterparty) when they believe it is appropriate or preferable to do so.

Under the first alternative, a covered swap entity may calculate its initial margin requirements using a standardized "lookup" table that specifies the minimum initial margin that must be collected as a percentage of the swap or security-based swap notional amount, which percentage varies depending on the broad asset class of the swap or security-based swap.[48] If the covered swap entity has entered into more than one swap or security-based swap with a counterparty (i.e., a portfolio of swaps), the aggregate minimum initial margin required on those swaps and security-based swaps would be determined by summing the minimum initial margin requirement for each individual swap.

In many cases, however, the use of a standardized table may not accurately reflect the risk of a portfolio of swaps or security-based swaps, because the swaps or security-based swaps themselves vary in ways not reflected by the standardized table or because no reduction in required initial margin to reflect offsetting exposures, diversification, and other hedging benefits is permitted, as discussed below. For this reason, the proposed rule includes a second alternative.

Under the second alternative, a covered swap entity may calculate its minimum initial margin requirements using an internal margin model that meets certain criteria and has been approved by the relevant prudential regulator.[49] Specifically, the covered swap entity must collect at least the amount of initial margin that is required under its internal model calculations (subject to any applicable initial margin threshold amount, as described below).

The Agencies request comment on whether the use of internal models or Appendix A is appropriate for the calculation of initial margin requirements. In particular, the Agencies request comment on the following questions:

Question 13. As an alternative to Appendix A, should the rule allow an alternative calculation method that would link the margin on a non-cleared swap or non-cleared security-based swap to the margin required by a derivatives clearing organization for a cleared swap or cleared security-based swap whose terms and conditions closely resemble the terms and conditions of the non-cleared swap or non-cleared security-based swap?

Question 14. Would there be enough similarity between cleared and non-cleared swaps or security-based swaps to make this approach workable?

Question 15. With respect to either alternative for calculating initial margin requirements, should swap or security-based swap positions that pose no counterparty risk to the covered swap entity, such as a sold call option with the full premium paid at inception of the trade, be excluded from the initial margin calculation?

The Agencies also request comment on whether offsetting exposures, diversification, and other hedging benefits of multiple derivatives transactions can or should be more accurately represented in Appendix A's standardized table. The Agencies note that although the use of an initial margin model will allow for significant recognition of offsetting exposures, diversification, and other hedging benefits of swap and security-based swap positions that are conducted under a qualifying master netting agreement, Appendix A's standardized table is based upon gross notional amounts and recognizes no offsetting exposures, diversification, or other hedging benefits. In particular, the gross notional amount may not accurately reflect the size or riskiness of the actual position in many circumstances. For example, with respect to a swap portfolio containing (i) a one year pay fixed and receive floating interest rate swap with a notional value of $10 million and (ii) a two year pay floating and receive fixed interest rate swap with a notional value of $10 million, an initial margin model would recognize that much of the risk of the one year swap is offset by the risk of the two year swap–changes in the level of interest rates that increase the value of the one year swap will simultaneously decrease the value of the two year swap. Under Appendix A, however, the gross notional interest rate swap position would be $20 million and the initial margin on the portfolio would be twice the initial margin of either $10 million swap even though the trades are, in fact, risk reducing.

The Agencies are concerned that the use of gross notional amounts alone in determining initial margin may not adequately recognize offsetting exposures, diversification, and other hedging benefits that are well understood as in the above example. This lack of recognition might lead to large disparities between a firm that uses a model to set initial margin and a firm that uses the standardized initial margin requirements. These disparities may give rise to significant competitive inequities between firms that do and do not adopt an approved initial margin model.

The Agencies request comment on possible changes to the standardized method of calculating initial margin requirements to better reflect the effect of offsets and hedging when swaps and security-based swaps are conducted under a qualifying master netting agreement. In particular, the Agencies seek comment on the following questions:

Question 16. Would calculating the standardized initial margin for a particular risk category by separately calculating the initial margin required on the long positions and short positions and then using

only the higher of these two amounts adequately account for offsetting exposures, diversification, and other hedging benefits within a standardized initial margin framework?

Question 17. Would the method described above systematically overestimate or underestimate offsetting exposures, diversification, and other hedging benefits? Is this method prone to manipulation or other gaming concerns?

Question 18. Should the Agencies consider some degree of offset across risk categories? If so how should these offsets be determined?

Question 19. Would adjusting the gross notional amount of swap positions in a particular risk category (e.g., commodity, credit, equity, or foreign exchange/interest rate) by a net-to-gross ratio or a netting factor in a manner that is similar to the method used for adjusting potential future exposure calculations for purposes of the Federal banking agencies' risk-based capital rules adequately capture offsetting exposures, diversification, and other hedging benefits?

Question 20. Would adjustment of gross notional amounts with a net-to-gross ratio or a netting factor systematically overestimate or underestimate offsetting exposures, diversification, and other hedging benefits?

Question 21. Are there additional methods that could be used in conjunction with a standardized lookup initial margin table that adequately recognize offsetting exposures, diversification, and other hedging benefits?

Question 22(a). Are such methods transparent and implementable? 22(b) Can they be generalized across multiple risk categories and swap types?

As an alternative, the Agencies request comment on whether Appendix A should be revised to adopt a method that more fully reflects the offsetting of positions at default. For example, such a method might rely on a calculation of an adjusted gross notional amount that would reduce the amount of initial margin required when a counterparty has many offsetting trades under a qualifying master netting agreement. To calculate the adjusted gross notional amount for an asset class, one would first calculate the net notional to gross notional ratio. This netting factor would be the absolute value of the difference between the long notional contracts and the short notional contracts divided by the total gross notional amount of the contracts. This value would then be used as a type of correlation factor among the contracts. The adjusted gross notional amount would then be calculated as follows, where n is the gross notional value of trades in an asset class and "NF" is the netting factor:

$$adjusted\ gross\ notional = n \times \frac{\sqrt{n + n(n-1)NF}}{n}$$

The adjusted gross notional amount, rather than the gross notional amount, would then be used to calculate initial margin using Appendix A.

When the netting factor is zero, initial margin would still be required to be collected, and when the net to gross ratio is one (all positions are one way) the netting factor is also one so that the adjusted gross notional is equal to the gross notional. This method would allow offsetting transactions that reduce risk to reduce initial margin, but would not allow the offset to ever be perfect, so that initial margin would always be required to be collected. The adjusted gross notional method would be applied to the initial margin calculation by using gross notional amounts within an asset class. The Agencies seek comment

on these methods, as well as alternative methods for calculating initial margin requirements under Appendix A and potential ways in which Appendix A might better capture the offsetting exposures, diversification, and other hedging benefits.

2. Initial Margin Thresholds.

As part of the proposed rule's initial margin requirements, a covered swap entity using either alternative is also permitted to establish, for counterparties that are low-risk financial end users or nonfinancial end users, a credit exposure limit below which it need not collect initial margin.[50] A covered swap entity is not permitted to establish an initial margin threshold amount for a counterparty that is either (i) a covered swap entity itself or (ii) a high-risk financial end user.[51]

This credit exposure limit is defined in the proposed rule as the initial margin threshold amount.[52] The maximum initial margin threshold amount that a covered swap entity may establish varies based on the relative risk of the counterparty, as determined by counterparty type (e.g., financial versus nonfinancial end user). With respect to a counterparty that is a low-risk financial end user, the proposed rule limits the maximum initial margin threshold amount that a covered swap entity may establish for a particular counterparty to the lower of (i) a range of $15 to $45 million or (ii) a range of 0.1 to 0.3 percent of the covered swap entity's tier 1 capital.[53] Although the Agencies have proposed a range of specific maximum initial margin threshold amounts for a counterparty that is a low-risk financial end user, the Agencies' preliminary view is that the midpoint of each range would in each case be an appropriate amount. With respect to counterparties that are nonfinancial end users, the proposed rule does not place a specific limit on the maximum initial margin threshold amount that a covered swap entity may establish.

The proposed rule allows uncollateralized exposures below the initial margin threshold amount for certain counterparties because taking uncollateralized credit exposure to counterparties is a long established business practice at the firms regulated by the Agencies. When well managed, taking on credit exposure does not automatically lead to unacceptable levels of systemic risk. Credit exposure can arise from a number of activities that regulated firms are permitted to engage in with a counterparty–making a loan, opening a committed line of credit, providing payments processing or transaction services, or engaging in swaps transactions. Although the proposal permits such credit exposure in certain circumstances, the proposed rule seeks to ensure that initial margin is collected in amounts that are appropriate to the risks posed by counterparties that are low-risk financial end users or nonfinancial end users.

The proposed rule requires that any credit exposure limit that a covered swap entity establishes as an initial threshold amount for a counterparty (i) appropriately take into account and address the credit risk posed by the counterparty and the risks of such swaps and security-based swaps and (ii) be reviewed, monitored, and approved in accordance with the swap entity's credit processes. Threshold amounts that are established in accordance with these standards are unlikely to generate meaningful risk to the safety and soundness of the covered swap entity and do not pose systemic risk.[54] In addition, in the case of counterparties that are low-risk financial end users, which the Agencies preliminarily believe pose greater risk than nonfinancial end users, the proposed rule imposes additional restrictions by limiting the maximum initial margin threshold amount that a covered swap entity may establish.

The Agencies expect that covered swap entities will establish initial margin threshold amounts only when they have meaningfully evaluated the creditworthiness of the counterparty and have made a credit and risk management decision to expose themselves to the unsecured credit of the counterparty pursuant to their generally applicable credit approval processes. The Agencies also expect that covered swap entities will monitor initial margin threshold amounts and adjust them downward to reflect any

deterioration in the credit quality of the counterparty or other increase in the risks the counterparties' swaps and security-based swaps pose. Under the proposed rule, even where an initial margin threshold amount is established, the covered swap entity must still calculate the initial margin amount for the counterparty pursuant to § __.3 of the proposed rule and, to the extent that the initial margin amount exceeds the initial margin threshold amount that has been established, collect initial margin equal to the excess amount.

For those counterparties that pose the greatest threat to systemic stability by virtue of their interconnectedness and the size of their uncollateralized and potential outward exposures–namely, other swap entities and high-risk financial end users–the proposed rule does not permit any exposure to remain uncollateralized; the threshold amount is effectively zero. It is the preliminary view of the Agencies that the potential systemic risk from other swap entities should lead to an amount of initial margin being actually collected. Margin should also be collected for all non-cleared swaps and non-cleared security-based swaps with high-risk financial end users because, as previously discussed, they are more likely to default during periods of financial stress and thus pose greater systemic risk and risk to the safety and soundness of the covered swap entity.

The Agencies request comment regarding whether it is appropriate to permit covered swap entities to establish initial margin threshold amounts for certain counterparties in the manner proposed. In particular, the Agencies request comment on the following questions:

Question 23(a). Does the maximum initial margin threshold amount proposed for counterparties that are low-risk financial end users strike an appropriate balance between traditional credit extension practices and the potential for systemic risk or risk to the safety and soundness of a covered swap entity? 23(b) Should threshold amounts for nonfinancial end users be subject to a similar limit? 23(c) If so, at what maximum amount or amounts? 23(d) Do the derivatives activities and exposures of nonfinancial end users have the potential to create systemic risk, either individually or in aggregate?

Question 24. Is it appropriate for the threshold amounts to be capped at a fixed dollar amount?

Question 25. Should the rule also place a limit on the threshold amounts that a covered swap entity establishes for all counterparties in the aggregate?

Question 26(a). Is it appropriate for the threshold amounts to be determined by reference to the tier 1 or other measure of capital of a covered swap entity? 26(b) What other measures might be used to determine appropriate threshold amounts?

Question 27(a). Should the various threshold amounts be subject to an automatic adjustment for inflation on a periodic basis? 27(b) If so, what type of adjustment would be appropriate?

3. Minimum Transfer Amount.

In addition, the proposed rule provides for a minimum transfer amount for the collection of margin by covered swap entities, under which a covered swap entity need not collect initial margin from any individual counterparty otherwise required under the proposed rule until the required cumulative amount is $100,000 or more.[55]

4. Alternative Approach to Initial Margin Requirements

The Agencies also request comment on several alternative approaches to implementation of the

initial margin requirements.

First, the Agencies request comment on whether the proposed rule should be augmented by (i) imposing a separate, additional requirement that a covered swap entity post initial margin to any counterparty that is an end user, including both financial and nonfinancial end users and (ii) requiring the covered swap entity to ensure that any such initial margin posted is segregated at a third-party custodian. In particular, the Agencies request comment on the following questions:

Question 28. Would requiring a covered swap entity to post initial margin to end user counterparties reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)?

Question 29. Are there alternatives that address those risks more efficiently or with greater transparency?

Question 30. Would requiring a covered swap entity to post initial margin to end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity, taking into consideration the requirement that initial margin be segregated and held with a third party custodian?

Question 31. Would requiring a covered swap entity to post initial margin to end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging initial margin?

Question 32. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Second, the Agencies request comment on whether the proposed rule should be augmented by (i) imposing a separate, additional requirement that a covered swap entity post initial margin to any end user counterparty that is a systemically significant financial institution under Title I of Dodd-Frank Act, and (ii) requiring the covered swap entity to ensure that any such initial margin posted is segregated at a third-party custodian. In particular, the Agencies request comment on the following questions:

Question 33. Would requiring a covered swap entity to post initial margin to systemically-significant end user counterparties reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)?

Question 34. Are there alternatives that address those risks more efficiently or with greater transparency?

Question 35. Would requiring a covered swap entity to post initial margin to systemically-significant end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity, taking into consideration the requirement that initial margin be segregated and held with a third party custodian?

Question 36. Would requiring a covered swap entity to post initial margin to systemically-significant end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging initial margin?

Question 37. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Third, the Agencies request comment on whether the proposed rule should establish a distinct category of covered swap entities that, because of the relatively small size of the derivatives activities and the lesser risk they pose to U.S. financial stability, would be subject to less stringent initial margin requirement. In particular, such an approach would (i) permit such "low-risk" covered swap entities to establish larger initial or additional margin threshold amounts (e.g., for counterparties that are swap entities) and (ii) not require such "low-risk" covered swap entities to comply with the segregation requirements of § __.7 of the proposed rule. Such low-risk covered swap entities could be defined by identifying a particular threshold amount of derivatives activities below which one would be considered a low-risk covered swap entity. For example, under this approach, a low-risk covered swap entity might be defined as a covered swap entity whose total positions in swaps and security-based swaps are below the applicable thresholds established by the SEC and CFTC for determining whether a firm is a major swap participant or major security-based swap participant, respectively. In particular, the Agencies request comment on the following questions:

Question 38. Would establishing a category of low-risk covered swap entity and subjecting that category to less stringent initial margin requirements enhance or reduce systemic risk?

Question 39. Would establishing a category of low-risk covered swap entity and subjecting that category to less stringent initial margin requirements raise any concerns with respect to the safety and soundness of such an entity?

Question 40. If the Agencies adopted such an approach, how should a low-risk covered swap entity be defined? Should the definition reference the thresholds established by the SEC and CFTC for determining whether a firm is a major swap participant or major security-based swap participant, or some variant of those thresholds?

Question 41. What less stringent initial margin requirements should apply to such low-risk covered swap entities? What, if any, segregation requirement should apply to such low-risk covered swap entities?

Question 42. Would such an approach encourage covered swap entities to separate their derivatives activities into multiple entities so as to avail themselves of the exemption?

Question 43. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

D. Section __.4: Variation Margin

Section __.4 of the proposed rules specifies the manner in which a covered swap entity must calculate the variation margin requirement applicable to swaps and security-based swaps it enters into. As with initial margin requirements, (i) these variation margin requirements apply only to collection of variation margin by covered swap entities from their counterparties, and not to the posting of variation margin to their counterparties,[56] and (ii) establish only a minimum amount of variation margin that must be collected, leaving covered swap entities free to collect larger amounts if they so choose. Consistent with current practice, covered swap entities and their counterparties would remain free to negotiate the extent to which a covered swap entity may be required to post variation margin to a counterparty (other than a swap entity that is itself subject to margin requirements).

The proposed rule generally requires a covered swap entity to collect variation margin from its counterparties on a periodic basis.[57] The amount of variation margin that is required to be periodically collected must be equal to or greater than (i) the cumulative mark-to-market change in value to the covered swap entity of a swap or security-based swap, as measured from the date it is entered into, less

(ii) the value of all variation margin previously collected but not returned by the covered swap entity with respect to such swap or security-based swap.[58]

1. Variation Margin Thresholds and Minimum Transfer Amounts.

Similar to the initial margin requirement under § __.3 of the proposed rule, § __.4 permits a covered swap entity to establish, for certain counterparties that are end users, a credit exposure limit that acts as a variation margin threshold below which it need not collect variation margin.[59] Although the variation margin threshold is separate from, and may be applied independently from, the initial margin threshold with respect to qualifying counterparties, the variation margin threshold amount that a covered swap entity may establish for counterparties that are low-risk financial end users is subject to the same specified maximum amount that governs initial margin threshold amounts for such counterparties. As with initial margin threshold amounts, a covered swap entity may not establish a variation margin threshold amount for counterparties that are swap entities or high-risk financial end users.

In addition, the proposed rule's variation margin requirements contain provisions similar to those governing initial margin with respect to minimum transfer amounts.

2. Aggregate Calculation of Variation Margin Requirements under a Qualifying Master Netting Agreement.

The proposed rule permits a covered swap entity to calculate variation margin requirements on an aggregate basis across all swap or security-based swap transactions with a counterparty that are executed under the same qualifying master netting agreement.[60] The proposed rule defines a qualifying master netting agreement as a legally enforceable agreement to offset positive and negative mark-to-market values of one or more swaps or security-based swaps that meet a number of specific criteria designed to ensure that these offset rights are fully enforceable, documented and monitored by the covered swap entity.[61] The Agencies request comment regarding whether permitting the aggregate calculation of variation margin requirements is appropriate and, if so, whether the proposed rule's definition of qualifying master netting agreement raises practical or implementation difficulties or is inconsistent with current market practices.

3. Frequency of Variation Margin Calculation and Collection.

The proposed rule also specifies the minimum frequency with which a covered swap entity must calculate and collect initial margin. Consistent with the approach of the proposed rule generally, the minimum frequency varies based on the systemic and safety and soundness risk of the counterparty type. Covered swap entities must calculate and collect variation margin from counterparties that are themselves swap entities or financial end users at least once per business day, and from counterparties that are nonfinancial end users at least once per week. The Agencies request comment on whether the proposed rule's approach to the frequency with which the variation margin requirements must be met is consistent with current market practices, and whether alternative approaches to imposing variation margin requirements would better reflect the purposes of section 731 and 764 of the Dodd-Frank Act.

4. Counterparty Refusal to Provide Required Variation Margin

Section __.4(e) of the proposed rule addresses potential circumstances in which a counterparty may refuse to provide required variation margin to a covered swap entity. Specifically, it provides that a covered swap entity shall not be deemed to have violated its regulatory obligation to collect required variation margin from a counterparty if the counterparty has refused or otherwise failed to provide the

required variation margin to the covered swap entity and the covered swap entity has either (i) made the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction of the relevant Agency that it has made appropriate efforts to collect the required variation margin, or (ii) commenced termination of the swap or security-based based swap with the counterparty.[62] The Agencies note that, in each such case, the covered swap entity will have been required, under § __.5 of the proposed rule, to obtain the contractual right to collect such variation margin as is necessary to permit it to comply with the requirements of § __.4 of the proposed rule and set out valuation dispute resolution procedures.

5. Alternative Approach to Variation Margin Requirements

The Agencies also request comment on several alternative approaches to implementation of the variation margin requirements.

First, the Agencies request comment on whether the proposed rule should be augmented by imposing a separate, additional requirement that a covered swap entity post variation margin to any counterparty that is an end user, including both financial and nonfinancial end users. In particular, the Agencies request comment on the following questions:

Question 44. Would requiring a covered swap entity to post variation margin to end user counterparties reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)?

Question 45. Are there alternatives that address those risks more efficiently or with greater regulatory transparency?

Question 46. Would requiring a covered swap entity to post variation margin to end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity?

Question 47. Would requiring a covered swap entity to post variation margin to end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging variation margin?

Question 48. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Second, the Agencies request comment on whether the proposed rule should be augmented by imposing a separate, additional requirement that a covered swap entity post variation margin to any end user counterparty that is a systemically significant financial institution under Title I of Dodd-Frank Act. In particular, the Agencies request comment on the following questions:

Question 49. Would requiring a covered swap entity to post variation margin to systemically-significant end user counterparties reduce systemic risk (e.g., by reducing leverage in the financial system or reducing systemic vulnerability to the failure of a covered swap entity)?

Question 50. Are there alternatives that address those risks more efficiently or with greater regulatory transparency?

Question 51. Would requiring a covered swap entity to post variation margin to systemically-significant end user counterparties raise any concerns with respect to the safety and soundness of the covered swap entity?

Question 52. Would requiring a covered swap entity to post variation margin to systemically-significant end user counterparties remove one or more incentives for that covered swap entity to choose, where possible, to structure a transaction so that it need not be cleared through a CCP in order to avoid pledging variation margin?

Question 53. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

Third, the Agencies request comment on whether the proposed rule should establish a distinct category of swap entities that, because of the relatively small size of the derivatives activities and the lesser risk they pose to U.S. financial stability, would be subject to less stringent variation margin requirement. In particular, such an approach would permit such "low- risk" covered swap entities to establish larger variation margin threshold amounts. Such low-risk covered swap entities could be defined as described in section III.C.4 of this notice. In particular, the Agencies request comment on the following questions:

Question 54. Would establishing a category of low-risk covered swap entity and subjecting such an entity to less stringent variation margin requirements enhance or reduce systemic risk?

Question 55. Would establishing a category of low-risk covered swap entity and subjecting such an entity to less stringent variation margin requirements raise any concerns with respect to the safety and soundness of such an entity?

Question 56. If the Agencies adopted such an approach, how should a low-risk covered swap entity be defined? What less stringent variation margin requirements should apply to such low risk covered swap entities?

Question 57. Would such an approach encourage covered swap entities to separate their derivatives activities into multiple entities so as to avail themselves of the exemption?

Question 58. Would this approach be consistent with the statutory factors the Agencies are directed to take into account under sections 731 and 764 of the Dodd-Frank Act?

E. Section __.5: Documentation of Margin Matters

The proposed rule requires a covered swap entity to execute trading documentation with each counterparty that includes credit support arrangements that grant the covered swap entity the contractual right to collect initial margin and variation margin in such amounts, in such form, and such circumstances as are required by the initial margin and variation margin requirements set forth in the proposed rule.[63] The trading documentation must also specify (i) the methods, procedures, rules, and inputs for determining the value of each swap or security-based swap for purposes of calculating variation margin requirements and (ii) the procedures by which any disputes concerning the valuation of swaps or security-based swaps, or the valuation of assets collected or posted as initial margin or variation margin, may be resolved.[64]

F. Section __.6: Eligible Collateral

The proposed rule specifies the types of collateral that are eligible to be collected to satisfy either the initial margin or variation margin requirements. Under the proposed rule, eligible collateral is limited

to: (i) immediately available cash funds (denominated in either U.S. dollars or in the currency in which payment obligations under the swap are required to be settled); (ii) any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, the United States; (iii) with respect to initial margin only, any senior debt obligations of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks and Farmer Mac; and (iv) with respect to initial margin only, any obligation that is an "insured obligation," as that term is defined in 12 U.S.C. 2277a(3), of the Farm Credit System banks.[65] Other than immediately-available cash funds, all types of eligible collateral are subject to discounts or minimum "haircuts" for purposes of determining their value for margin purposes, which haircuts are identified in Appendix B of the proposed rule.[66] Because the value of noncash collateral may vary, the proposed rule requires covered swap entities to monitor the value of noncash collateral previously collected to satisfy initial or variation margin requirements and, to the extent the value of such noncash collateral has decreased, to collect additional collateral with a sufficient value to ensure that all applicable initial and variation margin requirements remain satisfied.[67] The proposed rule also prohibits a covered swap entity from collecting, as required initial margin or variation margin, collateral that is an obligation of the counterparty pledging such collateral.[68]
The proposed rule does not allow for the use of non-cash collateral, other than the limited types of highly-liquid, high-quality debt securities described above, to satisfy the margin requirements. The appropriateness of using non-cash collateral to fulfill margin requirements is complicated by procyclical considerations. During a period of financial stress, the value of non-cash collateral pledged as margin may also come under stress just as counterparties default and the non-cash collateral is required to offset the cost of replacing defaulted swap positions. In addition, given the infinite variety of potential types of noncash collateral, it is extremely difficult to establish accurate haircuts by regulation. Also, for nonfinancial end users, who are the most likely type of counterparty to wish to post noncash collateral, the proposed rules provide credit exposure thresholds, under which a covered swap entity may determine the extent to which available noncash collateral appropriately reduces the covered swap entity's credit risk, consistent with its credit underwriting expertise. Similarly, counterparties that wish to rely on other non-cash assets to meet margin requirements could pledge those assets with a bank or group of banks in a separate arrangement, such as a secured financing facility, and could draw cash from that arrangement to meet margin requirements.

The Agencies request comment on whether the proposed rule's list of eligible noncash collateral for initial margin and variation margin is appropriate in scope**.** In particular, the Agencies request comment on the following questions:

Question 59(a). Should the types of eligible collateral listed be broadened to include other types of assets (e.g. securities backed by high-quality mortgages or issued with a third-party guarantee)? 59(b) If so, how might the systemic risk issue described above be effectively mitigated?

Question 60(a). Should the types of eligible collateral listed be broadened to include immediately-available cash funds denominated in foreign currency, even where such currency is not the currency in which payment obligations under the swap are required to be settled? 60(b) If so, which currencies (e.g., those accepted by a derivatives clearing organization as initial margin for a cleared swap)? 60(c) If so, what haircut, if any, should apply to such foreign currency?

Question 61. What criteria and factors could be used to determine the set of acceptable non-cash collateral?

Question 62. How could appropriate haircuts be determined for valuing these assets for margin purposes?

Question 63(a). Should the types of eligible collateral listed be broadened to include foreign sovereign debt securities? 63(b) If so, which foreign sovereign debt securities (e.g., those accepted by a derivatives clearing organization as initial margin for a cleared swap)? 63(c) If so, what haircut, if any, should apply?

Question 64(a). Should fixed income securities issued by a well-known seasoned issuer that has a high credit standing, are unsubordinated, historically display low volatility, are traded in highly liquid markets, and have valuations that are readily calculated be added to the list of eligible collateral for initial margin? 64(b) If so, how should the concept of a "high credit standing" be defined in a way that does not reference credit ratings?

G. Section __.7: Segregation of Collateral

The proposed rule provides that each covered swap entity must require each derivatives counterparty that it faces that is a swap entity to segregate any funds or collateral that the covered swap entity has posted as initial margin for a non-cleared swap or non-cleared security-based swap transaction at an independent, third-party custodian.[69] This independent, third-party custodian must be prohibited by contract from (i) rehypothecating or otherwise transferring any initial margin it holds for the covered swap entity and (ii) reinvesting any initial margin held by the custodian in any asset that would not qualify as eligible collateral for initial margin under the proposed rule.[70] The custodian must also be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity.[71] This segregation requirement applies only to initial margin, not variation margin, and does not apply to transactions with a counterparty that is an end user of any type.[72]

The Agencies' preliminary view is that requiring covered swap entities to ensure segregation of initial margin is necessary to (i) offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and (ii) protect the safety and soundness of the covered swap entity. In developing this proposal, the Agencies have taken into account the fact that the failure of a covered swap entity could pose significant systemic risks to the financial system and losses borne by the financial system in such a failure could have significant consequences. The consequences could be magnified if the initial margin posted to the failing swap entity cannot be quickly recovered by the nondefaulting party during a period of financial stress when the liquidity value of the funds is high. Moreover, swap entities typically have roughly offsetting exposures with one another. As a result, it is to be expected that the amount of initial margin required to be posted by two swap entities will be similar. If swap entities exchange similar amounts of initial margin and these funds are available for general use and rehypothecation by the swap entities, then the net effect is as if little initial margin was exchanged. To the extent that initial margin requirements are intended to constrain risk-taking, a lack of segregation will weaken their effect.[73]

Swap entities that engage in cleared swap transactions will be required to post initial margin to the CCP. Consequently, the initial margin that is posted on cleared transactions will not be available for rehypothecation by swap entities. Allowing for rehypothecation of initial margin by swap entities would create an incentive for swap entities to engage in non-cleared transactions even though other provisions of Dodd-Frank Act are intended to promote central clearing of swaps. However, the segregation of initial margin is likely to significantly reduce the availability of liquid assets to covered swap entities to meet payment obligations, as liquid assets held or pledged as the initial margin would be unavailable to the swap entity for other purposes. The requirement to segregate initial margin could result in covered swap entities having to seek alternative methods of funding. The loss in liquidity could be severe, and could require covered swap entities to raise liquidity through other sources.

The Agencies are concerned that not requiring segregation at the outset may cause covered swap entities that incur a severe loss due to credit or market events to face liquidity challenges because their counterparties may require segregation immediately after the loss, depleting the covered swap entity's liquid assets before it can raise additional funds through other means.[74] Requiring swap entities to segregate at the outset addresses this concern at the time a swap entity suffers a loss, but depletes the liquid assets at the inception of the swap transaction–a time when the swap entity is more likely to be able to raise additional liquid funds. The Agencies request comment on whether the proposed segregation requirement is appropriate, or whether an alternative approach would better reflect the purposes of sections 731 and 764 of the Dodd-Frank Act. In particular, the Agencies request comment on the following questions:

Question 65(a). Is it necessary to require segregation of initial margin in order to address the systemic risk issues discussed above? 65(b) What alternatives to segregation would effectively address these systemic risk issues? 65(c) As an alternative to requiring segregation at the outset, should the Agencies impose rules that provide additional time for a swap dealer to raise funds without requiring segregation?

Question 66(a). What are the potential operational, liquidity and credit costs of requiring segregation of initial margin by swap entities? 66(b) What would be the expected liquidity impact and cost of the proposed segregation requirement on market participants? How can the impact of the proposed rule on the liquidity and costs of swaps market participants be mitigated?

Question 67. Is segregation of initial margin and not variation margin sufficient to achieve the purposes of sections 731 and 764 of the Dodd-Frank Act? If not, how might such purposes be achieved?

Question 68(a). Are the limitations placed on rehypothecation and reinvestment under the proposed rule appropriate or necessary? 68(b) What additional or alternative limitations may be appropriate? 68(c) Should certain forms of rehypothecation (e.g., the lending of securities pledged as collateral) or additional types of reinvestment be permitted?

Question 69(a). Is the proposed rule's requirement that the custodian must be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity necessary or appropriate? 69(b) What additional or alternative requirements regarding the location of the custodian may be appropriate?

H. Section __.8: Approved Initial Margin Models

Section __.8 of the proposed rule contains modeling standards that an initial margin model must meet in order for a covered swap entity to calculate initial margin under such a model. Generally, the modeling standards are consistent with current regulatory rules and best practices for such models in the context of risk-based capital rules applicable to insured depository institutions and bank holding companies, and are no less conservative than those generally used by derivatives clearing organizations and clearing agencies.[75] As a result, the Agencies preliminarily believe that these modeling standards should ensure that a non-cleared swap does not pose a greater systemic risk than a cleared swap. In particular, because non-cleared swaps are expected to be less liquid than cleared swaps, the proposed rule specifies a minimum time horizon for the initial margin model of 10 business days, compared with a typical requirement of 3 to 5 business days used by derivatives CCPs.[76]

The proposed rule permits a covered swap entity to use an internal initial margin model that reflects offsetting exposures, diversification, and other hedging benefits within four broad risk categories (commodity, credit, equity, foreign exchange/interest rates) when calculating initial margin for a

particular counterparty if the relevant swaps or security-based swaps are executed under the same qualifying master netting agreement.[77] The proposed rule does not permit an initial margin model to reflect offsetting exposures, diversification, or other hedging benefits across broad risk categories.[78] It is the preliminary view of the Agencies that the correlations of exposures across broad risk categories are not stable enough to be incorporated into a regulatory margin requirement.

The Agencies request comment on whether the standards for initial margin models specified in the proposed rule are sufficient to ensure the integrity of initial margin calculations using such a model. In particular, the Agencies request comment on the following questions:

Question 70(a). Should such models be limited to models based on value-at-risk concepts, or are other models appropriate to measure initial margin? 70(b) If so, how should those models apply and be incorporated into the various aspects of the proposed rule?

Question 71(a). Should offsetting exposures, diversification, and other hedging benefits be recognized more broadly across substantially dissimilar asset classes? 71(b) If so, what limits, if any, would be placed on the recognition of offsetting exposures, diversification, and other hedging benefits, and how could these be measured, monitored and validated on an ongoing and consistent basis across substantially dissimilar asset classes?

Question 72(a). Should the minimum time horizon vary across swaps? 72(b) For example, should it vary based on the broad asset classes: commodity, credit, equity, and foreign exchange/interest rate? 72(c) If so, how should the horizons differ and what would be the basis for the different horizons?

1. Stress Calibration

In addition to a time horizon of 10 trading days, the proposed rule requires the initial margin model to be calibrated to a period of financial stress.[79] Calibration to a stress period ensures that the resulting initial margin requirement is robust to a period of financial stress during which swap entities and financial counterparties are more likely to default. Such calibration also reduces the systemic risk associated with any increase in margin requirements that might occur in response to a large increase in volatility during a period of financial stress.

The Agencies request comment on whether the proposed requirement that an initial margin model take into account financial stress is appropriate given the purpose the initial margin model is intended to serve. In particular, the Agencies request comment on the following questions:

Question 73. Can initial margin models be robustly calibrated to a stress period in a transparent and consistent manner?

Question 74. Are there any other systemic risk implications of requiring that initial margin be calibrated to a period of financial stress rather than to a recent or normal historical period?

Question 75. Is the proposed prudential standard for initial margin of a 99th percentile price move over a 10 day horizon, calibrated using historical data incorporating a period of significant financial stress, appropriate?

Question 76. Is a 10-day horizon sufficient to cover the likely liquidation period on non-cleared swaps?

Question 76. Will the requirement to calibrate to a period of significant financial stress reduce the

potential procyclicality of the margin requirement sufficiently? For example, would a minimum margin requirement as a backstop to the modeled initial margin amounts be a prudent approach to addressing procyclicality concerns?

Question 77. Is "period of significant financial stress" a well-understood concept? How might it be clarified?

Question 78. What would be the benefits and costs of replacing the requirement to calibrate the initial margin model using a period of significant financial stress with a requirement to calibrate the initial margin model using a longer historical data sample (such as 10 years), as an alternative way to reduce the potential procyclicality of the margin requirement?

Question 79. Should market participants be able to comply with the requirement to calibrate the initial margin requirement to a historical period of significant financial stress for newer products with little, if any, market history? If so, how?

2. Benchmarking

The proposed rule requires that an initial margin model used for calculating initial margin requirements be benchmarked periodically against observable margin standards to ensure that the initial margin required is not less than what a derivatives clearing organization or a clearing agency would require for similar transactions.[80] This benchmarking requirement is intended to insure that any initial margin amount produced by an initial margin model is subject to a readily observable minimum. It will also have the effect of limiting the extent to which the use of initial margin models might disadvantage the movement of certain types of derivatives to CCPs by setting lower initial margin amounts for non-cleared transactions than for similar cleared transactions.

The Agencies request comment on the proposed requirement for covered swap entities to benchmark any initial margin model to a model used by a derivatives clearing organization or clearing agency model for calculating initial margin, as well as the following questions:

Question 80. What are the operational costs associated with the benchmarking exercise?

Question 81. Can portfolio effects be captured during the benchmarking exercise?

Question 82. How would a banking organization fulfill the requirement in the event that a derivatives clearing organization or clearing agency does not clear a similar derivative transaction?

Section __.9: Application of Margin Requirements to Certain Foreign Covered Swap Entities

Section __.9 of the proposed rule addresses the manner in which the proposed rule's margin requirements apply to certain foreign covered swap entities. In the absence of § __.9, the proposed rule's margin requirements would apply to all of a covered swap entity's non-cleared swap and non-cleared security-based swap transactions, without regard to whether (i) the covered swap entity is organized under U.S. or foreign law or (ii) the covered swap entity's counterparty is located inside or outside of the United States. However, the potential application of the margin rules to foreign covered swap entities, or to transactions by U.S. covered swap entities with foreign counterparties, raises several important questions. First, the potential application of the proposed rule to activities conducted by a foreign covered swap entity wholly outside of the United States raises questions regarding the permissible territorial scope of the proposed rule.[81] Second, to the extent that the proposed margin requirements apply to transactions

involving foreign covered swap entities or foreign counterparties, such application could subject these transactions to multiple, and potentially conflicting, margin requirements established by U.S. and foreign regulators. Third, the potentially different treatment of U.S. covered swap entities and foreign covered swap entities raises questions of competitive equality among the two types of firms.

With respect to U.S. covered swap entities, the Agencies propose to apply the margin requirements to U.S. covered swap entities' swap and security-based swap transactions without regard to whether the counterparty is located inside or outside the United States. This approach acknowledges that the foreign swap and security-based swap transactions of a U.S. covered swap entity pose no lesser risk to the covered swap entity's safety and soundness and to financial stability based on the location of the counterparty. The proposed rule applies that same approach to covered swap entities that are foreign subsidiaries and offices of U.S. firms.
With respect to foreign covered swap entities, the Agencies propose to exclude certain qualifying foreign derivative transactions of such entities from application of the proposed rule's margin requirements. Specifically, § __.9 of the proposed rule provides that the proposed rule's margin requirements would not apply to any "foreign non-cleared swap or foreign non-cleared security-based swap" of a "foreign covered swap entity," as those terms are defined in § __.9 of the proposed rule.[82] This proposed approach limits the extra-territorial application of the margin requirements while preserving, to the extent possible, competitive equality among U.S. and foreign firms in the United States.

For these purposes, the proposed rule defines a "foreign non-cleared swap or foreign non-cleared security-based swap" as a non-cleared swap or non-cleared security-based swap with respect to which: (i) the counterparty to the foreign covered swap entity is not a company organized under the laws of the United States or any State, not a branch or office of a company organized under the laws of the United States or any State, and not a person resident in the United States; and (ii) performance of the counterparty's obligations to the foreign covered swap entity under the swap or security-based swap has not been guaranteed by an affiliate of the counterparty that is a company organized under the laws of the United States or any State, a branch of a company organized under the laws of the United States or any State, or a person resident in the United States.[83] As a result, foreign swaps and security-based swaps would generally only include transactions where the counterparty is not organized under U.S. law or otherwise located in the United States, and no U.S. affiliate of the counterparty has guaranteed the counterparty's obligations under the transaction.[84]

The additional requirement that no U.S. affiliate guarantee the counterparty's obligation is intended to exclude instances where such an affiliate has, through a guarantee, effectively assumed ultimate responsibility for the performance of the counterparty's obligations under the transaction. In particular, the Agencies are concerned that without such a requirement, swaps and security-based swaps with a U.S. counterparty could be structured, through the use of an overseas affiliate, in a manner that would evade application of the proposed margin requirements to U.S. transactions. Transactions guaranteed by a U.S. affiliate would also have direct and significant connection with activities in, and effect on, commerce of the United States.

The proposed rule defines a "foreign covered swap entity" as a covered swap entity that: (i) is not a company organized under the laws of the United States or any State; (ii) is not a branch or office of a company organized under the laws of the United States or any State; (iii) is not a U.S. branch, agency or subsidiary of a foreign bank; and (iv) is not controlled, directly or indirectly, by a company that is organized under the laws of the United States or any State.[85] Accordingly, only a covered swap entity that is organized under foreign law and not controlled, directly or indirectly, by a U.S. company would be eligible for treatment as a foreign covered swap entity for these purposes; neither a foreign branch of a U.S. insured depository institution nor a foreign subsidiary of a U.S. company would be considered a

foreign covered swap entity under the proposed rule. In cases where a U.S. company has a foreign subsidiary that is a covered swap entity, the proposed rule would treat that foreign subsidiary in the same manner as a U.S. covered swap entity for purposes of the margin requirements because the U.S. parent company's ownership of the subsidiary is likely to expose the U.S parent company, as a result of legal, contractual or reputational factors, to the risks of the foreign subsidiary's derivatives activities. Transactions of a foreign subsidiary of a U.S. company would also have direct and significant connection with activities in, and effect on, commerce of the United States. Similarly, neither a U.S. branch of a foreign bank nor a U.S. subsidiary of a foreign company would be a foreign covered swap entity under the proposed rule.

The Agencies request comment on the proposed rule's application to the U.S. and foreign swap and security-based swap activities of U.S. covered swap entities and foreign swap entities, respectively. In particular, the Agencies request comment on the following questions:

Question 83. Does the proposed rule's treatment of the swap and security-based swap transactions of foreign covered swap entities appropriately limit application of the margin requirements in a manner consistent with the territorial scope of sections 731 and 764 of the Dodd-Frank Act?

Question 84(a). Is the proposed rule's treatment of the foreign swap and security-based swap transactions of U.S. covered swap entities appropriate? 84(b) Should such transactions be subject to the same exclusion that has been proposed for the foreign swap and security-based swap transactions of foreign covered swap entities? 84(c) If so, why?

Question 85(a). Should the proposed rule expand the definition of foreign covered swap entity to include (i) the foreign subsidiaries of U.S. companies or (ii) the foreign branches of U.S. insured depository institutions? 85(b) If so, why? 85(c) How could the potential risks to the U.S. parent company or insured depository institution related to its subsidiary or branch's activity be limited or eliminated? 85(d) Is this operationally feasible?

Question 86. What impact is the proposed rule's treatment of the foreign swap and security-based swap transactions of U.S. covered swap entities likely to have on the structure, management, and/or competitiveness of U.S. covered swap entities?

Question 87(a). Is the proposed rule's definition of a foreign swap or security-based swap transaction appropriate? 87(b) In particular, is the requirement that no U.S. affiliate guarantee the foreign counterparty's obligations under the swap or security-based swap transaction appropriate? 87(c) Would an alternative definition more appropriately differentiate between U.S. and foreign counterparties for these purposes? 87(d) If so, what should that definition be?

Question 88(a). Is the proposed rule's definition of a foreign covered swap entity appropriate? 88(b) Would an alternative definition more appropriately differentiate between U.S. and foreign counterparties for these purposes? 88(c) If so, what should that definition be?

Question 89(a). Is the proposed rule's application of the margin requirements to all U.S. swaps and security-based swaps of a covered swap entity, regardless of whether that covered swap entity is U.S. or foreign, appropriate? 89(b) Should the proposed rule treat such transactions differently? 89(c) If so, how?

Question 90. What impact is the proposed rule's treatment of the swap and security-based swap transactions of foreign covered swap entities likely to have on the structure, management, and/or

competitiveness of foreign covered swap entities?

J. Section __.10: Capital

The proposed rule generally requires a covered swap entity to comply with regulatory capital rules already made applicable to that covered swap entity as part of its prudential regulatory regime, as follows:

- In the case of insured depository institutions, the capital adequacy guidelines that are applicable to the covered entity and have been adopted by the appropriate Federal banking agency under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o);
- In the case of a bank holding company or savings and loan holding company (on or after the transfer established under Section 311 of the Dodd-Frank Act), the capital adequacy guidelines applicable to bank holding companies under the Board's Regulation Y (12 CFR Part 225);
- In the case of a foreign bank or the U.S. branch or agency of a foreign bank, the capital rules that are made applicable to such covered entity pursuant to § 225.2(r)(3) of the Board's Regulation Y (12 CFR 225.2(r)(3);
- In the case of an Edge corporation or an Agreement corporation, the capital adequacy guidelines that are made applicable to an Edge corporation engaged in banking pursuant to § 211.12(c)(2) of the Board's Regulation K (12 CFR 211.12(c)(2);
- In the case of any "regulated entity" under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (i.e., Fannie Mae and its affiliates, Freddie Mac and its affiliates, and the Federal Home Loan Banks), the risk-based capital level or such other amount applicable to the covered swap entity as required by the Director of FHFA pursuant to 12 U.S.C. 4611;
- In the case of Farmer Mac, the capital adequacy regulations set forth in 12 CFR Part 652; and
- In the case of any Farm Credit System institution (other than Farmer Mac), the capital regulations set forth in 12 CFR Part 615.[86]

The Agencies have preliminarily determined that compliance with these regulatory capital requirements is sufficient to offset the greater risk to the swap entity and the financial system arising from the use of non-cleared swaps, helps ensure the safety and soundness of the covered swap entity, and is appropriate for the greater risk associated with the non-cleared swaps and non-cleared security-based swaps held as a covered swap entity. In particular, the Agencies note that the capital rules incorporated by reference into the proposed rule already address, in a risk-sensitive and comprehensive manner, the safety and soundness risks posed by a covered swap entity's derivatives positions.[87] In addition, the Agencies preliminarily believe that these capital rules sufficiently take into account and address the risks associated with the derivatives positions that a covered swap entity holds and the other activities conducted by a covered swap entity.[88]

The Agencies request comment regarding whether application of these capital regimes is appropriate.

Question 91. Is an alternative or additional capital requirement appropriate for some or all of the covered swap entities subject to the proposed rule?

Question 92. Are there particular issues or concerns raised in the context of foreign banks or their U.S.

branches and agencies that would be better addressed through a different approach to the capital requirement for such entities?

K. Section __.11: Special Requirements for Transactions Between Swap Entities and Regulated Entities

FHFA and FCA (but not the other Agencies) are proposing an additional provision, § __.11 of FHFA's and FCA's proposed rules. Proposed § __.11 would require that any entity that is regulated by FHFA or FCA, but is not itself a covered swap entity, collect initial margin and variation margin from its counterparty when entering into a non-cleared swap or non-cleared security-based swap with a swap entity.[89] Regulated entities subject to this provision include the Federal Home Loan Banks, Fannie Mae and its affiliates, Freddie Mac and its affiliates, and all Farm Credit System institutions including Farmer Mac (collectively, regulated entities, and each a regulated entity). Regulated entities that are swap entities would be subject to §§ 1 through 9 of the proposed rule by virtue of being covered swap entities. This section also does not apply to swaps entered into between regulated entities and end users.

Proposed § __.11 is consistent with the risk-based approach to margin proposed by the Agencies and parallels the requirements that swap entities collect initial and variation margin from their counterparties. Moreover, this approach recognizes that a default by a swap counterparty to a regulated entity could adversely affect the safe and sound operations of the regulated entity. The requirement reflects current practice in that the regulated entities generally obtain collateral to secure their swaps exposure to swap dealer counterparties, although current practice generally does not include posting of initial margin by or to any counterparty.
FHFA and FCA are proposing these provisions pursuant to each agency's role as safety and soundness regulator for its respective regulated entities, and each agency's authority to ensure that the regulated entities operate in a safe and sound manner, including that they maintain adequate capital and internal controls, that their activities foster liquid, efficient, competitive and resilient national finance markets for housing, agriculture, and rural markets, and that they carry out their public policy missions through authorized activities.[90]

Section __.11(a)(1) of the proposed rule requires a regulated entity to collect initial margin when it enters into a swap transaction with a swap entity. The proposal provides that the amount of initial margin the regulated entity must collect shall be in accordance with § __.3 of the proposed rule, which permits the use of either an initial margin model or the use of a standardized "look up" table specifying the minimum initial margin that must be collected as a percentage of the notional amount of the transaction. The minimum initial margin levels set out in Appendix A apply only in the absence of an initial margin model. FHFA and FCA, however, seek comment on whether a minimum initial margin requirement should apply as a backstop even to modeled initial margin amounts, as a prudent approach to address concerns about procyclicality and competitive pressures to reduce margin requirements. If not, how should such concerns be addressed?

Section __.11(a)(1) of the proposed rule permits a regulated entity to use its initial margin model to determine initial margin and provides that if the regulated entity does not have an initial margin model, it may engage a third party to calculate initial margin on its behalf, provided that the third party is itself independent of the swap entity that is the counterparty to the transaction. Any initial margin model used to determine margin posted to a regulated entity must meet all of the requirements of § __.8 of the proposed rule. FHFA and FCA preliminarily believe that permitting a swap entity to use its own model to calculate the amount of initial margin it would be required to post to a regulated entity may introduce a conflict of interest to the transaction. That concern could be addressed by establishing a process through which the regulated entity could verify the reasonableness of the counterparty's model calculation. FHFA

and FCA each seeks comment on whether it should allow its regulated entities to use the counterparty's model to calculate initial margin, and if so, what provisions should be included to mitigate conflicts of interest.

Section __.11(a)(2) of the proposed rule requires that a regulated entity collect variation margin daily from the swap entity in accordance with the requirements of § __.4 of the proposed rule, which permits the amounts of variation margin posted to be adjusted to account for qualifying master netting agreements and applies a minimum transfer amount of $100,000.

Section __.11(b) of the proposed rule requires that any regulated entity entering into a non-cleared swap or a non-cleared security-based swap with a swap entity must execute trading documentation with such counterparty in accordance with § __.5 of the proposed rule. Section __.11(c) of the proposed rule provides that any collateral that a regulated entity is required to collect as initial or variation margin must meet the eligible collateral requirements of § __.6 of the proposed rule. That section applies the same eligibility requirements to the regulated entities that are required of the swap entities.

Section __.11(d) of the proposed rule provides that a regulated entity must require that any initial margin it posts to a counterparty be held by an independent custodian. That provision is consistent with the requirement in § __.7 of the proposed rule that a covered swap entity require segregation with an independent custodian of any initial margin that it posts to another swap entity. Section __.11(d) of the proposed rule applies this segregation requirement to variation margin as well as initial margin and thereby reflects current practice of at least some of the regulated entities. FHFA and FCA seek comments on whether such a requirement should be applied to variation margin and if it is not applied, how the regulated entities would be protected in the event variation margin is posted to a swap entity that subsequently fails.

IV. Quantitative Impact of Margin Requirements

The proposed rule would apply the initial margin and variation margin requirements to non-cleared swaps and security-based swaps that are entered into by a covered swap entity after the effective date, which is proposed to be 180 days after publication of a final rule in the Federal Register. The proposed rule would not require an immediate or retroactive application of initial margin or variation margin for any derivative transaction entered into prior to the effective date of the final rule.

Because the requirements would not be applied retroactively, no new initial margin or variation margin requirements would be imposed on derivatives transactions entered into prior to the effective date until such time as those transactions are rolled-over or renewed. The only requirements that would apply to a pre-effective date covered derivative would be the initial margin and variation margin requirements to which the parties to the transaction had previously agreed to by contract.

The new requirements will have an impact on the costs of engaging in new swap transactions. In particular, the proposed rule sets out requirements for initial and variation margin that represent a significant change from current industry practice in many circumstances. Assessing the quantitative impact of the proposed requirements is particularly difficult in light of the wide ranging and as yet undetermined changes that are occurring to the derivatives market as a result of regulatory reform. Specifically there is significant uncertainty with respect to (i) which entities would be classified as swap entities; (ii) the extent to which existing derivatives would be rolled-over or renewed; and (iii) the extent to which derivatives currently traded on an over-the-counter basis will move to central clearing by a CCP. In addition, there are a number of specific and technical aspects of the proposed rule, such as

number and composition of counterparties that would be classified as high-risk financial end users, low-risk financial end users, and nonfinancial end users, respectively, that are difficult to assess without a large amount of highly detailed data on the size of derivative positions as well as the underlying rationale for maintaining those positions. These and other complicating factors make it difficult to make precise statements about the quantitative impact of the margin rule specified under the proposed rule.

Accordingly, the Agencies request commenters to provide their own detailed quantitative impact analyses. The Agencies encourage commenters to include the following elements in their analyses categorized between swaps entities, high-risk financial end users, low-risk financial end users, and nonfinancial end users: (i) required initial margin if internal models were applied; (ii) required initial margin if the standardized chart in Appendix A were applied; (iii) required variation margin; (iv) the expected costs of, or additional liquidity required by, the initial margin and variation margin requirements; and (v) the potential benefits of the initial margin and variation margin requirements to covered swap entities, their counterparties, and financial stability. The analyses should also (i) address operational and other business related costs associated with implementing the proposed rule and (ii) take into consideration and disclose the expected effect of the likely clearing of certain derivative transactions through CCPs in the future.

In order to better understand the effect that broader clearing requirements will have on the impact of the proposed rules, the Agencies also request comment on the levels of covered derivatives, including the roll-over or renewal of prior derivatives that would become covered under the proposed rule, that can be expected over the following time horizons after the effective date: (i) 1 year, (ii) 3 years, and (iii) 5 years. To maximize the usefulness of such comments, the Agencies request that commenters break down such projections by covered derivatives that are likely to be cleared and uncleared, as well as by product class.

V. Request for Comments.

The Agencies are interested in receiving comments on all aspects of the proposed rule.

VI. Solicitation of Comments on Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Pub. L. 106-102, sec. 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the OCC, Board and FDIC to use plain language in all proposed and final rules published after January 1, 2000. The OCC, Board and FDIC invite your comments on how to make this proposal easier to understand. For example:

- Have we organized the material to suit your needs? If not, how could this material be better organized?
- Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?
- Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?
- What else could we do to make the regulation easier to understand?

VII. Administrative Law Matters.

A. Paperwork Reduction Act Analysis

Request for Comment on Proposed Information Collection

Certain provisions of the proposed rule contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA"), 44 U.S.C. 3501-3521. In accordance with the requirements of the PRA, the Agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The information collection requirements contained in this joint notice of proposed rulemaking have been submitted by the FDIC, OCC, and FHFA to OMB for approval under section 3506 of the PRA and § 1320.11 of OMB's implementing regulations (5 CFR part 1320). The Board reviewed the proposed rule under the authority delegated to the Board by OMB.

Comments are invited on:

(a) Whether the collections of information are necessary for the proper performance of the agencies' functions, including whether the information has practical utility;
(b) The accuracy of the estimates of the burden of the information collections, including the validity of the methodology and assumptions used;
(c) Ways to enhance the quality, utility, and clarity of the information to be collected;
(d) Ways to minimize the burden of the information collections on respondents, including through the use of automated collection techniques or other forms of information technology; and
(e) Estimates of capital or start up costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record. Commenters may submit comments on aspects of this notice that may affect disclosure requirements and burden estimates at the addresses listed in the ADDRESSES section of this Supplementary Information. A copy of the comments may also be submitted to the OMB desk officer for the agencies: By mail to U.S. Office of Management and Budget, 725 17th Street, NW, #10235, Washington, DC 20503 or by facsimile (202-395-5806).

Title of Information Collection: Margin and Capital Requirements for Certain Swap Entities.

Frequency of Response: Event-generated and annual.

Affected Public: The affected public of the FDIC, OCC, and Board is assigned generally in accordance with the entities covered by the scope and authority section of their respective proposed rule. The affected public of FHFA generally would be those third parties not regulated by a prudential regulator that request prior written approval of an initial margin model for use by a regulated entity.

FDIC: Any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System or FDIC-insured state-chartered savings association that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.

OCC: Any national bank, Federal savings association, or Federal branch or agency of a foreign bank that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.

Board: Any state member bank (as defined in 12 CFR 208.2(g)), bank holding company (as defined in 12

U.S.C. 1842), savings and loan holding company (as defined in 12 U.S.C. 1467a, (on or after the transfer established under Section 311 of the Dodd-Frank Act)12 U.S.C. 5411)), foreign banking organization (as defined in 12 CFR 211.21(o)), state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), or Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)) that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant.

FHFA: With respect to any regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)), the proposed rule would not contain any collection of information pursuant to the PRA. However, the provisions in proposed § __.11(e) allowing a third party that is not subject to regulation by a prudential regulator to request prior written approval of an initial margin model for use by a regulated entity, would be a collection of information under the PRA.

Abstract: The notice sets forth proposed margin and capital requirements with respect to non-cleared swaps and non-cleared security-based swaps for covered swap entities. The information requirements in joint regulations proposed by the Agencies are found in §§ __.2(t)(3), _.2(t)(4), _.4(e)(2)(i), __5, __.6(d)(2)(i), __.8(c)(1), __.8(c)(2), __8(c)(3), __8(d)(3), __8(d)(8), __.8(d)(9), __.8(d)(10), __.8(d)(12), __.8(e)(1), __.8(f)(2), __.8(f)(3), __.8(f)(4), and __.8(g). Compliance with the information collections found in sections __.2(t)(3) and _.2(t)(4) would be mandatory for any covered swap entity wishing to take a qualifying master netting agreement into account for purposes of calculating initial margin or variation margin. Compliance with the information collections found in §§ __.4(e)(2)(i), __.5, and _.6(d)(2)(i) would be mandatory for all covered swap entities. Compliance with the information collections found in §§ __.8(c)(1), __.8(c)(2), __.8(c)(3), __.8(d)(3), __.8(d)(8), __.8(d)(9), __.8(d)(10), __.8(d)(12), __.8(e)(1), __.8(f)(2), __.8(f)(3), __.8(f)(4), and __.8(g) would be mandatory for all covered swap entities wishing to use an initial margin model to calculate initial margin requirements.

In addition, § __.11(e) of FHFA's proposed rule contains an information collection that would be for all third parties that are not subject to regulation by a prudential regulator and that request prior written approval of an initial margin model for use by an FHFA-regulated entity.

Section-by-Section Analysis

Section _.2 defines terms used in the proposed rule, including the definition of "qualifying master netting agreement" contained in § __2(t). Sections __.2(t)(3) and __.2(t)(4) provide that, with respect to a qualifying master netting agreement, a covered swap entity must (i) conduct sufficient legal review of the agreement to conclude with a well-founded basis that the agreement meets specified criteria and (ii) establish and maintain procedures for monitoring relevant changes in law. The term "qualifying master netting agreement" is used elsewhere in the proposed rule to specify instances in which a covered swap entity may (i) calculate variation margin on an aggregate basis across multiple swaps and security-based swaps and (ii) calculate initial margin requirements under an initial margin model on a portfolio basis.

Section _.4 requires that on and after the date on which a covered swap entity enters into a non-cleared swap or non-cleared security-based swap, the covered swap entity shall collect variation margin from the counterparty to such swap or security-based swap in specified amounts. Section __.4(e)(2)(i) requires that, in cases where a counterparty refuses to provide required variation margin, a covered swap entity demonstrated upon request to the satisfaction of the relevant Agency that it has made appropriate efforts to collect the required variation margin unless it has otherwise made the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms.

Section __.5 requires a covered swap entity to execute trading documentation with each counterparty that (i) includes credit support arrangements that grant the covered swap entity the contractual right to collect initial margin and variation margin in such amounts, in such form, and such circumstances as are required by the initial margin and variation margin requirements set forth in the proposed rule and (ii) meets other specified criteria.

Section __.6 establishes certain forms of eligible collateral that a covered swap entity shall collect for initial margin and variation margin required pursuant to this part and requires a covered swap entity to monitor the market value of any eligible collateral it has collected to satisfy initial margin or variation margin required by this part and, to the extent that the market value of such collateral has declined, collect such additional eligible collateral as is necessary to bring itself into compliance with the margin requirements of this part. Section __.6(d)(2)(i) requires that, in cases where a counterparty refuses to provide required additional margin, a covered swap entity demonstrated upon request to the satisfaction of the relevant Agency that it has made appropriate efforts to collect the required additional margin unless it has otherwise made the necessary efforts to attempt to collect the required additional margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms.

Section __.8 establishes standards for initial margin models. These standards include:

- requirement that the covered swap entity receive prior approval from the relevant Agency based on demonstration that the initial margin model meets specific requirements (§§ __.8(c)(1) and __.8(c)(2)); · A requirement that a covered swap entity notify the relevant Agency in writing before extending use of the model to additional product types, making certain changes to the initial margin model, or making material changes to modeling assumptions (§ __.8(c)(3));
- A variety of quantitative requirements, including requirements that the covered swap entity validate and demonstrate the reasonableness of its process for modeling and measuring hedging benefits, demonstrate to the satisfaction of the relevant Agency that the omission of any risk factor from the calculation of its initial margin is appropriate, demonstrate to the satisfaction of the relevant Agency that any conversion of initial margin calculated using a different holding period is appropriate, periodically review and, as necessary, revise the data used to calibrate the initial margin model to ensure that the data incorporate an appropriate period of significant financial stress (§§ __.8(d)(3), __.8(d)(8), __.8(d)(9), __.8(d)10), __.8(d)(12));
- A requirement that a covered swap entity review its initial margin model annually (§ __.8(e));
- A requirement that the covered swap entity validate its initial margin model initially and on an ongoing basis, describe to the relevant Agency any remedial actions being taken, and report internal audit findings regarding the effectiveness of the initial margin model to the covered swap entity's board of directors or a committee thereof (§§ __.8(f)(2), __.8(f)(3), and __.8(f)(4)); and
- A requirement that the covered swap entity adequately document all material aspects of its initial margin model (§ __.8(g)).

Section __.11(e) of FHFA's proposed rule applies § __.8 of the proposed rule, the information collection of which is described above, to any third party that is not subject to regulation by a prudential regulator and requests prior written approval of an initial margin model for use by an FHFA-regulated entity.

<u>Estimated Paperwork Burden</u>

Estimated Burden Per Response:

§ __.2 – Definitions, § __.5 – Documentation of margin matters, and § __.8(g) –Documentation: recordkeeping – 5 hours.

§ __.4(e)(2)(i) – Variation margin and § __.6(d)(2)(i) – Eligible collateral: recordkeeping -- 4 hours.

§ __.8(c) and (d) – Initial margin model: reporting – 240 hours.

§ __.8(e) -- Periodic review and § __.8 (f) – Control, oversight and validation mechanisms: recordkeeping – 40 hours.

§ __.11(e) – Special requirements for transactions between swap entities and regulated entities: Initial margin models: recordkeeping – 220 hours.

FDIC

Number of Respondents: 3.

Total Estimated Annual Burden: 867 hours.

OCC

Number of Respondents: 20.

Total Estimated Annual Burden: 5,780 hours.

Board

Number of Respondents: 30.

Total Estimated Annual Burden: 8,670 hours.

FHFA

Number of Respondents: 2.

Total Estimated Annual Burden: 440 hours.

FCA: The FCA collects information from Farm Credit System institutions, which are Federal instrumentalities, in the FCA's capacity as their safety and soundness regulator, and, therefore, OMB approval is not required for this collection.

B. Initial Regulatory Flexibility Act Analysis

In accordance with section 3(a) of the Regulatory Flexibility Act, 5 U.S.C. 601 et. seq. (RFA), the Agencies are publishing an initial regulatory flexibility analysis for the proposed rule. The RFA requires an agency to provide an initial regulatory flexibility analysis with the proposed rule or to certify that the

proposed rule will not have a significant economic impact on a substantial number of small entities. The Agencies welcome comment on all aspects of the initial regulatory flexibility analysis. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period.

1. Statement of the objectives of the proposal. As required by section 4s of the Commodity Exchange Act (7 U.S.C. 6(s)) and section 15F of the Securities Exchange Act (15 U.S.C. 78o-8), the Agencies are proposing new regulations to establish rules imposing (i) capital requirements and (ii) initial and variation margin requirements on all non-cleared swaps into which the covered swap entities enter.

2. Small entities affected by the proposal. This proposal may have an effect predominantly on two types of small entities: (i) financial institutions that are swap entities that are subject to the proposed rule's capital and margin requirements; and (ii) counterparties that engage in derivatives transactions with swap entities that are subject to the proposed rule's margin requirements.

With respect to financial institutions that are swap entities that are subject to the proposed rule's margin requirement, a financial institution generally is considered small if it has assets of $175 million or less.[91] Based on 2010 Call Report data, approximately 4,200 depository institutions had total domestic assets of $175 million or less. Of this number, however, the Agencies do not expect that any is likely to be a swap entity that is subject to the proposed rule's capital and margin requirements. With respect to counterparties that engage in derivatives transactions with swap entities that are subject to the proposed rule's margin requirements, the number of such counterparties and the extent to which certain types of companies are likely to be counterparties are unknown. However, of the 4,200 depository institutions described above, fewer than 250 are party to non-cleared derivative contracts.

3. Compliance requirements. With respect to the initial margin and variation margin requirements, the Agencies' proposed rule does not apply directly to counterparties that engage in derivatives transactions with swap entities. However, because the proposed rule requires a covered swap entity to collect a minimum amount of margin (subject to a threshold in some cases) from all counterparties, including small entities, the margin requirements may affect the amount of margin that counterparties that are small entities are required to post to dealer counterparties when transacting in the derivatives markets. Accordingly, the Agencies expect any economic impact on counterparties that are small entities to be negative to the extent that swap entities currently do not collect initial margin or variation margin from those counterparties but would be required to do so under the proposed rule.

4. Other Federal rules. The Agencies believe that no Federal rules duplicate, overlap, or conflict with the proposed rule.

5. Significant alternatives to the proposed rule. As discussed above, the Agencies have requested comment on the impact of the margin requirements on end users from which swap entities may be required to collect initial margin and/or variation margin and have solicited comment on any approaches that would reduce the burden on all counterparties, including small entities. In addition, the Agencies have proposed to reduce the effect of the proposed rule on counterparties to covered swap entities, including small entities, through the implementation of initial margin threshold amounts and variation margin threshold amounts. The Agencies have also requested comment on a variety of alternative approaches to implementing margin requirements with respect to swaps and security-based swaps with counterparties that are end users. The Agencies welcome comment on any significant alternatives that would minimize the impact of the proposal on small entities.

FCA: Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 601 et seq., FCA

hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities; nor does the Federal Agricultural Mortgage Corporation meet the definition of "small entity." Therefore, System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

FHFA: FHFA believes that the proposed rule, if promulgated as a final rule, would not have a significant economic impact on a substantial number of small entities, since none of FHFA's regulated entities come within the meaning of small entities as defined in the Regulatory Flexibility Act (see 5 U.S.C. 601(6)), and would not substantially affect any business that its regulated entities might do with small entities.

C. OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Public L. 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million (adjusted for inflation) or more in any one year. The current inflation-adjusted expenditure threshold is $126.4 million. If a budgetary impact statement is required, section 205 of the UMRA also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million (adjusted for inflation) or more in any one year. The current inflation-adjusted expenditure threshold is $126.4 million. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

The OCC has determined this proposed rule is likely to result in the expenditure by the private sector of $126.4 million or more. Therefore, the OCC has prepared a budgetary impact analysis and identified and considered alternative approaches. The full text of the OCC's analyses under the Unfunded Mandates Act is available at: http://www.regulations.gov, Docket ID OCC-2011-0008.

Text of the Proposed Common Rules

(All Agencies)

The text of the proposed common rules appears below:

PART [ ]— MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

____.1 Authority, purpose, and scope
____.2 Definitions
____.3 Initial margin
____.4 Variation margin

____.5 Documentation of margin matters
____.6 Eligible collateral
____.7 Segregation of collateral
____.8 Initial margin models
____.9 Application of margin requirements to certain foreign covered swap entities
____.10 Capital
Appendix A to Part [ ] -- Standardized minimum initial margin requirements for non-cleared swaps and non-cleared security-based swaps
Appendix B to Part [ ] -- Margin values for noncash collateral

§ __.1 Authority, purpose, and scope.

[Reserved]

§ __.2 Definitions.

(a) Clearing agency has the meaning specified in section 3(a)(23) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(23)).

(b) Counterparty means, with respect to any swap or security-based swap to which a covered swap entity is a party, the counterparty to such swap or security-based swap, other than a counterparty that is a derivatives clearing organization or clearing agency.

(c) [Reserved]

(d) Derivatives clearing organization has the meaning specified in section 1a(15) of the Commodity Exchange Act (7 U.S.C. 1a(15)).

(e) Eligible collateral means collateral described in § __.6.

(f) Effective date means **[date that is 180 days after publication of the final rule in the Federal Register]**.

(g) End user means a counterparty that is not a swap entity.

(h) Financial end user means any counterparty that is an end user that is—

(1) A commodity pool as defined in section 1a(5) of the Commodity Exchange Act (7 U.S.C. 1a(5));

(2) A private fund as defined in section 202(a) of the Investment Advisors Act of 1940 (15 U.S.C. 80-b-2(a));

(3) An employee benefit plan as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1002);

(4) A person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company of 1956 (12 U.S.C. 1843(k));

(5) A person that would be a financial end user described in paragraph (h)(1) or (h)(2) of this section, if it were organized under the laws of the United States or any State thereof;

(6) A government of any foreign country or a political subdivision, agency, or instrumentality thereof; or

(7) Any other person that [Agency] may designate.

(i) High-risk financial end user means a counterparty that is a financial end user but is not a low-risk financial end user.

(j) Initial margin means eligible collateral that is pledged in connection with entering into a swap or security-based swap by a party thereto to secure the performance of its obligations to its counterparty under one or more swaps or security-based swaps.

(k) Initial margin collection amount means—

(1) In the case of a covered swap entity that does not have an initial margin model, the amount of initial margin with respect to a swap or security-based swap that is required under Appendix A of this part; and

(2) In the case of a covered swap entity that does have an initial margin model, the amount of initial margin with respect to a swap or security-based swap that is required under the initial margin model.

(l) Initial margin model means an internal risk management model that–

(1) Has been developed and designed to identify an appropriate, risk-based amount of initial margin that the covered swap entity must collect with respect to one or more swaps or security-based swaps to which the covered swap entity is a party; and

(2) Has been approved by [Agency] pursuant to § __.8 of this part.

(m) Initial margin threshold amount means a credit exposure limit that has been established by a covered swap entity with respect to its swaps and security-based swaps with a counterparty, that appropriately takes into account and addresses the credit risk posed by the counterparty and the risks of such swaps and security-based swaps, and that has been reviewed, monitored and approved in accordance with the covered swap entity's credit processes, except that in no case shall the threshold amount be greater than—

(1) Zero, if the counterparty is either a swap entity or a high-risk financial end user; or

(2) The lesser of [$15 to $45] million and [0.1 to 0.3] percent of the covered swap entity's [capital metric], if the counterparty is a low-risk financial end user.

(n) Low-risk financial end user means a counterparty that is a financial end user and makes the following representations to a covered swap entity in connection with entering into a swap or security-based swap with the covered swap entity—

(1) The counterparty does not have a significant swaps exposure;

(2) The counterparty predominantly uses swaps or security-based swaps to hedge or mitigate the risks of its business activities, including balance sheet, interest rate, or other risk arising from the business of the counterparty; and

(3) The counterparty is subject to capital requirements established by a prudential regulator or state insurance regulator.

(o) Margin means initial margin and variation margin.

(p) Non-cleared swap means a swap that is not a cleared swap, as that term is defined in section 1a(7) of the Commodity Exchange Act (7 U.S.C. 1a(7)).

(q) Non-cleared security-based swap means a security-based swap that is not, directly or indirectly, submitted to and cleared by a clearing agency registered with the SEC.

(r) Nonfinancial end user means any counterparty that is an end user but is not a financial end user.

(s) Prudential regulator has the meaning specified in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a(39)).

(t) Qualifying master netting agreement means an agreement governing one or more swaps or security-based swaps to which a covered swap entity is a party that satisfies the following criteria—

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including bankruptcy, insolvency, or similar proceeding, of the counterparty;

(2) The agreement provides the covered swap entity the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of bankruptcy, insolvency, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions;

(3) The covered swap entity has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that—

(i) The agreement meets the requirements of paragraph (t)(2) of this definition; and

(ii) In the event of a legal challenge (including one resulting from default or from bankruptcy, insolvency, or similar proceeding) the relevant court and administrative authorities would find the

agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions;

(4) The covered swap entity establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of this definition; and

(5) The agreement does not contain a provision that permits a non-defaulting counterparty to make a lower payment than it would make otherwise under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement.

(u) Security-based swap has the meaning specified in section 3(a)(68) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(68)).

(v) Significant swaps exposure means—

(1) Swap positions that equal or exceed any of the following thresholds—

(i) $2.5 billion in daily average aggregate uncollateralized outward exposure; or

(ii) $4 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure; or

(2) Security-based swap positions that equal or exceed any of the following thresholds—

(i) $1 billion in daily average aggregate uncollateralized outward exposure; or

(ii) $2 billion in daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure.

(3) For purposes of this definition—

(i) The terms daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure, when used with respect to swaps, each has the meaning specified for that term in [17 CFR 1.3(uuu)] for purposes of calculating substantial counterparty exposure under that regulation.

(ii) The terms daily average aggregate uncollateralized outward exposure and daily average aggregate potential outward exposure, when used with respect to security-based swaps, each has the meaning specified for that term in [15 CFR 240.3a67-5] for purposes of calculating substantial counterparty exposure under that regulation.

(w) State insurance regulator means an insurance authority of a State that is engaged in the supervision of insurance companies under State insurance law.

(x) Swap has the meaning specified in section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)).

(y) Swap entity means a security-based swap dealer as defined in section 3(a)(71) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(71)), a major security-based swap participant as defined in section 3(a)(67) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(67)), a swap dealer as defined in section 1a(49) of the Commodity Exchange Act (7 U.S.C. 1a(49)), or a major swap participant as defined in section 1a(33) of the Commodity Exchange Act (7 U.S.C. 1a(33)) .

(z) Variation margin means eligible collateral pledged or paid on an intraday, daily or other periodic basis by one party to a swap or security-based swap to its counterparty to offset a change in the value of one or more swaps or security-based swaps between the parties, as calculated in accordance with the contractual terms of such swaps or security-based swaps.

(aa) Variation margin amount means the cumulative mark-to-market change in value to a covered swap entity of a swap or security-based swap, as measured from the date it is entered into (or, in the case of swap or security-based swap that has a current positive or negative value to a covered swap entity on the date it is entered into, such positive or negative value plus any cumulative mark-to-market change in value to the covered swap entity of a swap or security-based swap after such date), less the value of all variation margin previously collected but not returned by the covered swap entity (expressed as a positive amount) with respect to such swap or security-based swap.

(bb) Variation margin threshold amount means a credit exposure limit that has been established by a covered swap entity with respect to its swaps and security-based swaps with a counterparty, that

appropriately takes into account and addresses the credit risk posed by the counterparty and the risks of such swaps and security-based swaps, and that has been reviewed, monitored and approved in accordance with the covered swap entity's credit processes, except that in no case shall the threshold amount be greater than—

(1) Zero, if the counterparty is a either a swap entity or a high-risk financial end user; or

(2) The lesser of [$15 to 45] million and [0.1 to 0.3]% of the covered swap entity's [capital metric], if the counterparty is a low-risk financial end user.

§ __.3 Initial margin.

(a) General. A covered swap entity shall collect initial margin with respect to any non-cleared swap or non-cleared security-based swap from the counterparty to such swap or security-based swap in an amount that is no less than the greater of—

(1) Zero; or

(2) The initial margin collection amount for such swap or security-based swap less the initial margin threshold amount for the counterparty (not including any portion of the initial margin threshold amount being applied to other swaps or security-based swaps with the counterparty), as applicable.

(b) Timing. A covered swap entity shall, with respect to any non-cleared swap or non-cleared security-based swap to which it is a party, comply with the initial margin requirements described in paragraph (a) for a period beginning on or before the date it enters into such swap or security-based swap and ending on the date the non-cleared swap or non-cleared security-based swap is terminated or expires.

(c) Minimum Transfer Amount. Notwithstanding anything else in this section, a covered swap entity is not required to collect initial margin pursuant to this section with respect to a particular counterparty unless and until the total amount of initial margin that is required pursuant to this section to be collected, but has not yet been collected, with respect to the counterparty is greater than $100,000.

§ __.4 Variation margin.

(a) General. On and after the date on which a covered swap entity enters into a non-cleared swap or non-cleared security-based swap, the covered swap entity shall, to the extent the variation margin amount for such swap or security-based swap is positive, collect variation margin from the counterparty to such swap or security-based swap in an amount that is no less than the greater of—

(1) Zero; or

(2) The variation margin amount for such swap or security-based swap less the variation margin threshold amount for the counterparty (not including any portion of the variation margin threshold amount being applied to other swaps or security-based swaps with the counterparty), as applicable.

(b) Frequency. A covered swap entity shall comply with the variation margin requirements described in paragraph (a) of this section—

(1) No less than once per business day with respect to a counterparty that is a swap entity or a financial end user; and

(2) No less than once per week with respect to a counterparty that is a nonfinancial end user.

(c) Minimum Transfer Amount. Notwithstanding anything else in this section, a covered swap entity is not required to collect variation margin pursuant to this section unless and until the total amount of variation margin that is required pursuant to this section to be collected, but has not yet been collected, with respect to the counterparty is greater than $100,000.

(d) Netting Arrangements. To the extent that one or more non-cleared swaps or non-cleared security-based swaps are executed pursuant to a qualifying master netting agreement between a covered swap entity and its counterparty, a covered swap entity may calculate and comply with the variation margin requirements of this paragraph on an aggregate basis with respect to all swaps and security-based swaps governed by such agreement, so long as the covered swap entity complies with these variation margin requirements with respect to all swaps and security-based swaps governed by such agreement regardless of whether the swaps and security-based swaps were entered into on or after the effective date.

(e) A covered swap entity shall not be deemed to have violated its obligation under paragraph (a) of this section to collect variation margin from a counterparty if—

(1) The counterparty has refused or otherwise failed to provide the required variation margin to the covered swap entity; and

(2) The covered swap entity has—

(i) Made the necessary efforts to attempt to collect the required variation margin, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction of [Agency] that it has made appropriate efforts to collect the required variation margin; or

(ii) Commenced termination of the swap or security-based swap with the counterparty.

§ __.5 Documentation of margin matters.

A covered swap entity shall execute trading documentation with each counterparty regarding credit support arrangements that—

(a) Provides the covered swap entity with the contractual right to collect initial margin and variation margin in such amounts, in such form, and under such circumstances as are required by this part; and

(b) Specifies—

(1) The methods, procedures, rules, and inputs for determining the value of each swap or security-based swap for purposes of calculating variation margin requirements; and

(2) The procedures by which any disputes concerning the valuation of swaps or security-based swaps, or the valuation of assets collected or posted as initial margin or variation margin, may be resolved.

§ __.6 Eligible collateral.

(a) A covered swap entity shall collect initial margin and variation margin required pursuant to this part solely in the form of one or more of the following types of eligible collateral—

(1) Immediately available cash funds that are denominated in—

(i) U.S. dollars; or

(ii) The currency in which payment obligations under the swap are required to be settled;

(2) Any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, the United States; and

(3) With respect to initial margin only—

(i) Any senior debt obligation of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Home Loan Banks and the Federal Agricultural Mortgage Corporation; and

(ii) Any obligation that is an "insured obligation," as that term is defined in 12 U.S.C. 2277a(3), of a Farm Credit System bank.

(b) The value of any eligible collateral described in paragraphs (a)(2) or (a)(3) of this section, for purposes of satisfying the initial margin or variation margin requirements of this part shall be subject to, and limited by, the discounts described in Appendix B of this part.

(c) A covered swap entity may not collect, as initial margin or variation margin required by this part, any collateral that is an obligation of the counterparty pledging such collateral.

(d) A covered swap entity shall monitor the market value of any eligible collateral it has collected to satisfy initial margin or variation margin required by this part and, to the extent that the market value of such collateral has declined, shall collect such additional eligible collateral as is necessary to bring itself into compliance with the margin requirements of this part. A covered swap entity shall not be deemed to have violated its obligation under this paragraph (d) to collect additional eligible collateral from a counterparty if—

(1) The counterparty has refused or otherwise failed to provide the required additional eligible

collateral to the covered swap entity; and

(2) The covered swap entity—

(i) Has made the necessary efforts to attempt to collect the required additional eligible collateral, including the timely initiation and continued pursuit of formal dispute resolution mechanisms, or has otherwise demonstrated upon request to the satisfaction of [Agency] that it has made appropriate efforts to collect the required additional eligible collateral; or

(ii) Has commenced termination of the swap or security-based swap with the counterparty.

(e) A covered swap entity may collect initial margin and variation margin that is not required pursuant to this part in any form of collateral.

§ __.7 Segregation of collateral.

A covered swap entity that enters into a non-cleared swap or non-cleared security-based swap with a swap entity and posts initial margin to the swap entity with respect to that swap or security-based swap shall require that—

(a) All funds or other property the covered swap entity provides as initial margin are held by a third-party custodian that is independent of the covered swap entity and the counterparty;

(b) The independent custodian is prohibited by contract from rehypothecating or otherwise transferring any initial margin held by the custodian;

(c) The independent custodian is prohibited by contract from reinvesting any initial margin held by the custodian in any asset that would not qualify as eligible collateral under § __.6 for purposes of satisfying the initial margin requirements of this part; and

(d) The independent custodian is located in a jurisdiction that applies the same insolvency regime to the independent custodian as would apply to the covered swap entity.

§ __.8 Initial margin models.

(a) General adequacy of initial margin model. Unless a covered swap entity's initial margin model conforms to the requirements of this section, the covered swap entity shall calculate all initial margin collection amounts pursuant to Appendix A of this part.

(b) Applicability to swaps and security-based swaps. Any initial margin model that a covered swap entity wishes to use to calculate the amount of initial margin required to be collected for a single swap or security-based swap transaction or a portfolio of swap and/or security-based swap transactions with a given counterparty pursuant to § __.3 must meet each requirement of this section. An initial margin model may be designed to calculate initial margin for a portfolio of swaps and/or security-based swaps only if all such swaps and/or security-based swaps are governed by the same qualifying master netting agreement. To the extent that a qualifying master netting agreement between a covered swap entity and its counterparty governs swaps or security-based swaps that were entered into before, on, and after the effective date, the covered swap entity may use its initial margin model to calculate the amount of initial margin required to be collected pursuant to § __.3 either—

(1) With respect to only those swaps and/or security-based swaps transactions entered into on and after the effective date; or

(2) With respect to all swaps and/or security-based swaps transactions governed by such qualifying master netting agreement, regardless of whether they were entered into before, on, or after the effective date.

(c) Requirements for initial margin model.

(1) A covered swap entity must obtain the prior written approval of [Agency] before using any initial margin model to calculate the initial margin required in this part.

(2) A covered swap entity must demonstrate that the initial margin model satisfies all of the requirements of this section on an ongoing basis.

(3) A covered swap entity must promptly notify [Agency] in writing prior to:

(i) Extending the use of an initial margin model that [Agency] has approved under this

section to an additional product type;

(ii) Making any change to any initial margin model approved by [Agency] under this section that would result in a material change in the covered swap entity's assessment of initial margin requirements; or

(iii) Making any material change to modeling assumptions used by the initial margin model.

(4) [The Agency] may rescind its approval of the use of any initial margin model, in whole or in part, or may impose additional conditions or requirements if [Agency] determines that the initial margin model no longer complies with this section.

(d) Quantitative Requirements.

(1) The covered entity's initial margin model must calculate an amount of initial margin that is equal to the potential future exposure of the swap, security based swap or portfolio of swaps and/or security-based swaps. Potential future exposure is an estimate of the one-tailed 99 percent confidence interval for an increase in the value of the swap, security-based swap or portfolio of swaps and/or security-based swaps due to an instantaneous price shock that is equivalent to a movement in all material underlying risk factors, including prices, rates, and spreads, over a holding period equal to the shorter of ten business days or the maturity of the swap or security-based swap. If a covered swap entity elects to calculate initial margin using an initial margin model on a portfolio of swaps and/or security-based swaps under the same qualifying master netting agreement, the covered entity must calculate an amount of initial margin for that portfolio each time a new swap or security-based swap is added to that portfolio and collect any incremental initial margin collection amount that is required.

(2) The covered swap entity's initial margin model must use risk factors sufficient to measure all material price risks inherent in the swap transactions for which initial margin is being calculated. The risk categories must include, but should not be limited to, foreign exchange/interest rate risk, credit risk, equity risk, and commodity risk, as appropriate. For material exposures in the major currencies and markets, modeling techniques must capture spread and basis risk and must incorporate a sufficient number of segments of the yield curve to capture differences in volatility and imperfect correlation of rates along the yield curve.

(3) The initial margin model may calculate initial margin for a portfolio of swaps and/or security-based swaps and reflect offsetting exposures, diversification, and other hedging benefits for swaps and security-based swaps that are governed by the same qualifying master netting agreement by incorporating empirical correlations within the following four broad risk categories, provided the covered swap entity validates and demonstrates the reasonableness of its process for modeling and measuring hedging benefits: commodity, credit, equity, and foreign exchange/interest rate. Offsetting exposures, diversification, and other hedging benefits under a qualifying master netting agreement may be recognized by the initial margin model within each broad risk category, but not across broad risk categories.

(4) If the initial margin model does not explicitly reflect offsetting exposures, diversification, and hedging benefits within a broad risk category, the covered swap entity must calculate an amount of initial margin separately for each subset of swaps and security-based swaps for which offsetting exposures, diversification, and other hedging benefits are explicitly recognized by the initial margin model. The sum of the initial margin amounts calculated for each subset of swaps and security-based swaps within a broad risk category will be used to determine the aggregate initial margin due from the counterparty for the portfolio of swaps and security-based swaps within the broad risk category.

(5) The sum of the initial margins calculated for each broad risk category will be used to determine the aggregate initial margin due from the counterparty.

(6) The initial margin model may not permit the calculation of any initial margin collection amount to be subject to offset by, or otherwise take into account, any initial margin that may be owed or otherwise payable by the covered swap entity to the counterparty.

(7) The initial margin model must include all material risks arising from the nonlinear price characteristics of options positions or positions with embedded optionality and the sensitivity of the

market value of the positions to changes in the volatility of the underlying rates, prices, or other material risk factors. As an example, a covered swap entity with a large or complex options portfolio must measure the volatility of options positions or positions with embedded optionality by different maturities and/or strike prices, where material.

(8) The covered swap entity may not omit any risk factor from the calculation of its initial margin that the covered swap entity uses in its initial margin model unless it has previously demonstrated to the satisfaction of [Agency] that such omission is appropriate.

(9) The covered swap entity may not incorporate any proxy or approximation used to capture the risks of the covered swap entity's actual swap or security-based swap transactions unless it has previously demonstrated to the satisfaction of [Agency] that such proxy or approximation is appropriate.

(10) The covered swap entity may calculate initial margin over the holding period directly or it may convert an initial margin calculated using a different holding period. A covered swap entity may not convert its initial margin calculation in such a manner unless it has previously demonstrated to the satisfaction of [Agency] that such conversion is appropriate.

(11) All data used to calibrate the initial margin model must be based on a historical observation period of at least one year and must incorporate a period of significant financial stress appropriate to the swap and/or security-based swap transactions to which the initial margin model is applied.

(12) The covered swap entity must review and, as necessary, revise the data used to calibrate the initial margin model at least monthly, and more frequently as market conditions warrant, to ensure that the data incorporate a period of significant financial stress appropriate to the swap and/or security-based swap transactions to which the initial margin model is applied.

(13) The level of sophistication of the initial margin model must be commensurate with the complexity of the swap and/or security-based swap transactions to which they are applied. In calculating an initial margin collection amount, the initial margin model may make use of any of the generally accepted approaches for modeling the risk of a single instrument or portfolio of instruments.

(14) The covered swap entity must periodically benchmark the initial margin model against observable margin standards to ensure that the initial margin required is not less than what a derivatives clearing organization or a clearing agency would require for similar transactions.

(15) [The Agency] may require a covered swap entity using an initial margin model to collect a greater amount of initial margin than that determined by the covered swap entity's initial margin model.

(e) Periodic review. A covered swap entity must periodically, but no less frequently than annually, review its initial margin model in light of developments in financial markets and modeling technologies, and enhance the initial margin model as appropriate to ensure that the initial margin model continues to meet the requirements for approval in this section.

(f) Control, oversight, and validation mechanisms.

(1) The covered swap entity must have a risk control unit that reports directly to senior management and is independent from the business trading units.

(2) The covered swap entity must validate its initial margin model initially and on an ongoing basis. The covered swap entity's validation process must be independent of the development, implementation, and operation of the initial margin model, or the validation process must be subjected to an independent review of its adequacy and effectiveness. The validation process must include:

(i) An evaluation of the conceptual soundness of (including developmental evidence supporting) the initial margin model;

(i) An ongoing monitoring process that includes verification of processes and benchmarking by comparing the covered swap entity's initial margin model outputs (estimation of initial margin) with relevant alternative internal and external data sources or estimation techniques; and

(ii) An outcomes analysis process that includes backtesting of the initial margin model.

(3) If the validation process reveals any significant problems with the initial margin model, the covered swap entity must notify [Agency] of the problems, describe to [Agency] any remedial actions

being taken, and adjust the initial margin model to insure an appropriately conservative amount of required initial margin is being calculated.

(4) The covered swap entity must have an internal audit function independent of business-line management that at least annually assesses the effectiveness of the controls supporting the covered swap entity's initial margin model measurement systems, including the activities of the business trading units and independent risk control unit, compliance with policies and procedures, and calculation of the covered swap entity's initial margin requirements under this part. At least annually, the internal audit function must report its findings to the covered swap entity's board of directors or a committee thereof.

(g) Documentation. The covered swap entity must adequately document all material aspects of its initial margin model, including management and valuation of swap and/or security-based swap transactions to which they apply, the control, oversight, and validation of the initial margin model, any review processes and the results of such processes.

§ __.9 Application of margin requirements to certain foreign covered swap entities.

(a) The requirements of §§ __.3 through __.8 shall not apply to any foreign non-cleared swap or foreign non-cleared security-based swap of a foreign covered swap entity.

(b) For purposes of this section, a foreign non-cleared swap or foreign non-cleared security-based swap is any non-cleared swap or non-cleared security-based swap transaction with respect to which–

(1) The counterparty to the foreign covered swap entity is–

(i) Not an entity organized under the laws of the United States or any State;

(ii) Not a branch or office of an entity organized under the laws of the United States or any State; and

(iii) Not a person resident in the United States; and

(2) Performance of the counterparty's obligations to the foreign covered swap entity under the swap or security-based swap has not been guaranteed by an affiliate of the counterparty that is–

(i) An entity organized under the laws of the United States or any State;

(ii) A branch or office of an entity organized under the laws of the United States or any State; or

(iii) A person resident in the United States.

(c) For purposes of this section, a foreign covered swap entity is any covered swap entity that is–

(1) Not a company organized under the laws of the United States or any State;

(2) Not a branch or office of a company organized under the laws of the United States or any State;

(3) Not a U.S. branch, agency or subsidiary of a foreign bank; and

(4) Not controlled, directly or indirectly, by a company that is organized under the laws of the United States or any State.

§ __.10 Capital.

[Reserved]

Appendix A to Part [ ] -- Standardized minimum initial margin requirements for non-cleared swaps and non-cleared security-based swaps.

Standardized Minimum Initial Margin Requirements for Non-cleared Swaps and Non-cleared Security-Based Swaps	

Asset Class	Initial Margin Requirement (% of Notional Exposure)
Credit: 0-2 year duration	[1-3]
Credit: 2-5 year duration	[2-8]
Credit: 5+ year duration	[5-15]
Commodity	[10-20]
Equity	[10-20]
Foreign Exchange/Currency	[3-9]
Interest Rate: 0-2 year duration	[0-2]
Interest Rate: 2-5 year duration	[1-3]
Interest rate: 5+ year duration	[2-6]
Other	[10-20]

Appendix B to Part [ ] -- Margin values for noncash collateral.

Margin Values for Noncash Collateral		
	Margin Value (% of Market Valu Duration (Years)	
	0-5	5-10
U.S. Treasuries and Fully Guaranteed Agencies		
Bills/Notes/Bonds/Inflation Indexed	[98-100]	[95-99]
Zero Coupon, STRIPs	[97-99]	[94-98]
Senior Debt Obligations of FHFA Regulated Entities and the Federal Agricultural Mortgage Corporation, and Insured Obligations of Farm Credit System Banks		
Bills/Notes/Bonds	[96-100]	[94-98]
Zero Coupon	[95-99]	[93-97]

[END OF COMMON TEXT]

Adoption of the Common Rule Text

The proposed adoption of the common rules by the agencies, as modified by agency-specific text, is set forth below:

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Chapter I

List of Subjects
12 CFR Part 45

Administrative practice and procedure, Capital, Margin requirements, National banks, Reporting and recordkeeping requirements, Risk.

Authority and Issuance

For the reasons stated in the Common Preamble, the Office of the Comptroller of the Currency proposes to amend chapter I of Title 12, Code of Federal Regulations as follows:

PART45 –MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

1. The authority citation for part 45 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 12 U.S.C. 1 et seq., 93a, 161, 1818, 3907, 3090, and 15 U.S.C. 78o-10(e).

2. Part 45 is added as set forth at the end of the Common Preamble.

3. Part 45 is amended by:
a. Removing "[Agency]" wherever it appears and adding in its place "the OCC";
b. Removing "[The Agency]" wherever it appears and adding in its place "The OCC"; and
c. Removing "[capital metric]" wherever it appears and adding in its place "Tier 1 capital".

4. Section 45.1 is added to read as follows:

§ 45.1 Authority, purpose, and scope.

(a) Authority. This part is issued under the authority of 7 U.S.C. 6s(e), 12 U.S.C. 1 et seq., 93a, 161, 1818, 3907, 3090, and 15 U.S.C. 78o-10(e).

(b) Purpose. Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o-8) require the OCC to establish capital and margin requirements for any national bank, Federal savings association, or Federal branch or agency of a foreign banks that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statutes' requirements.

(c) Scope. This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after **[insert date that is 180 days after publication of the final rule in the Federal Register**]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

5. Paragraph (c) of § 45.2 is added to read as follows:

§ 45.2 Definitions.

* * * * *

(c) Covered swap entity means any national bank, Federal savings association, or Federal branch and agency of a foreign bank that is a swap entity, or any other entity that the OCC determines.

* * * * *

6. Section 45.10 is added to read as follows:

§ 45.10 Capital.

A covered swap entity shall comply with:

(a) In the case of a covered swap entity that is a national bank, the minimum capital requirements in 12 CFR part 3;

(b) In the case of a covered swap entity that is a Federal savings association, the minimum capital requirements in 12 CFR part 567; and

(c) In the case of a covered swap entity that is a Federal branch or agency of a foreign bank, the capital adequacy guidelines that are applicable as generally provided under 12 CFR 28.14.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
12 CFR Chapter II

List of Subjects
12 CFR Part 237

Administrative practice and procedure, Banks and banking, Capital, Foreign banking, Holding companies, Margin requirements, Reporting and recordkeeping requirements, Risk.

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Board of Governors of the Federal Reserve System proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 237 to 12 CFR Chapter II as follows:

PART 237 —MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES (REGULATION KK)

7. The authority citation for part 237 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o-10(e), 12 U.S.C. 221 et seq., 12 U.S.C. 1818, 12 U.S.C. 1841 et seq., and 12 U.S.C. 3103 et seq..

8. Part 237 is added as set forth at the end of the Common Preamble.

9. Part 237 is amended by:
a. Removing "[Agency]" wherever it appears and adding in its place "the Board";
b. Removing "[The Agency]" wherever it appears and adding in its place "The Board"; and
c. Removing "[capital metric]" wherever it appears and adding in its place "tier 1 capital".

10. Section 237.1 is added to read as follows:

§ 237.1 Authority, purpose, and scope.

(a) Authority. This part (Regulation KK) is issued by the Board of Governors of the Federal Reserve System ((Board) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)) and section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)), as well as under the Federal Reserve Act, as amended (12 U.S.C. 221 et seq.); section 8 of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1818); the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.); and the International Banking Act of 1978, as amended (12 U.S.C. 3101 et seq.).

(b) Purpose. Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o-8) require the Board to establish capital and margin

requirements for any state member bank (as defined in 12 CFR 208.2(g)), bank holding company (as defined in 12 U.S.C. 1842), savings and loan holding company (as defined in 12 U.S.C. 1467a (on or after the transfer established under Section 311 of the Dodd-Frank Act)12 U.S.C. 5411)), foreign banking organization (as defined in 12 CFR 211.21(o)), state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), or Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)) that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statutes' requirements.

(c) Scope. This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after **[insert date that is 180 days after publication of the final rule in the Federal Register**]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

11. Paragraph (c) of § 237.2 is added to read as follows:

§ 237.2 Definitions.

* * * * *

(c) Covered swap entity means any state member bank (as defined in 12 CFR 208.2(g)), bank holding company (as defined in 12 U.S.C. 1842), savings and loan holding company (as defined in 12 U.S.C. 1467a (on or after the transfer established under Section 311 of the Dodd-Frank Act)12 U.S.C. 5411)), foreign banking organization (as defined in 12 CFR 211.21(o)), any state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), or Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)) that is a swap entity, or any other entity that the Board determines.

* * * * *

12. Section 237.10 is added to read as follows:

§ 237.10 Capital.

A covered swap entity shall comply with:

(a) In the case of a covered swap entity that is a state member bank (as defined in 12 CFR 208.2(g)), the capital adequacy guidelines that are applicable to the covered swap entity and have been adopted by the Board under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o);

(b) In the case of a covered swap entity that is a bank holding company (as defined in 12 U.S.C. 1842) or a savings and loan holding company (as defined in 12 U.S.C. 1467a), the capital adequacy guidelines applicable to bank holding companies under the Board's Regulation Y (12 CFR Part 225);

(c) In the case of a covered swap entity that is foreign banking organization (as defined in 12 CFR 211.21(o)) or any state branch or state agency of a foreign bank (as defined in 12 U.S.C. 3101(b)(11) and (12)), the capital rules that are made applicable to such covered swap entity pursuant to § 225.2(r)(3) of the Board's Regulation Y (12 CFR 225.2(r)(3)); and

(d) In the case of a covered swap entity that is an Edge or agreement corporation (as defined in 12 CFR 211.1(c)(2) and (3)), the capital adequacy guidelines that are made applicable to an Edge corporation engaged in banking pursuant to § 211.12(c)(2) of the Board's Regulation K (12 CFR 211.12(c)(2)).

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Chapter III

List of Subjects
12 CFR Part 324

Banks, Reporting and recordkeeping requirements, Holding companies, Savings associations.

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Federal Deposit Insurance Corporation proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 324 to chapter III of Title 12, Code of Federal Regulations, modified as follows:

PART 324 —MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

13. The authority citation for part 324 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o-10(e), and 12 U.S.C. 1818 and 12 U.S.C. 1819(a)(Tenth).

14. Part 324 is added as set forth at the end of the Common Preamble.

15. Part 324 is amended by:
a. Removing "[Agency]" wherever it appears and adding in its place "the FDIC";
b. Removing "[The Agency]" wherever it appears and adding in its place "The FDIC"; and
c. Removing "[capital metric]" wherever it appears and adding in its place "tier 1 capital".

16. Section 324.1 is added to read as follows:

§ __.1 Authority, purpose, and scope.

(a) Authority. This part is issued by the Federal Deposit Insurance Corporation (FDIC) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)), section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)), and section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818).

(b) Purpose. Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o-8) require the FDIC to establish capital and margin requirements for any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System or FDIC-insured state-chartered savings association that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This part implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statutes and related terms, establishing capital and margin requirements, and explaining the statutes' requirements.

(c) Scope. This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after **[insert date that is 180 days after publication of the final rule in the Federal Register**]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

17. Paragraph (c) of § 324.2 is added to read as follows:

* * * * *

(c) Covered swap entity means any FDIC-insured state-chartered bank that is not a member of the Federal Reserve System or FDIC-insured state-chartered savings association that is a swap entity, or any other entity that the FDIC determines.

* * * * *

18. Section 324.10 is added to read as follows:

§ __.10 Capital requirement.

A covered swap entity shall comply with the capital adequacy guidelines that are applicable to the covered swap entity and have been adopted by the FDIC under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o).

FARM CREDIT ADMINISTRATION
12 CFR Part 624

List of Subjects

Agriculture, Banks, Banking, Credit, Rural areas.

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Farm Credit Administration proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 624 to chapter VI of Title 12, Code of Federal Regulations, modified as follows:

PART 624 —MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

19. The authority citation for part 624 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o-10(e), and secs. 4.3, 5.9, 5.17, and 8.32 of the Farm Credit Act (12 U.S.C. 2154, 12 U.S.C. 2243, 12 U.S.C. 2252, and 12 U.S.C. 2279bb-1).

20. Part 624 is added as set forth at the end of the Common Preamble.

21. Part 624 is amended by:

a. Removing "[Agency]" wherever it appears and adding in its place "the FCA";

a. Removing "[The Agency]" wherever it appears and adding in its place "The FCA"; and

c. Removing "[capital metric]" wherever it appears and adding in its place "core surplus or core capital, as applicable".

22. Section 624.1 is added to read as follows:

§ 624.1 Authority, purpose, and scope.

(a) Authority. This part is issued by the Farm Credit Administration (FCA) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)), section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)), and sections 4.3, 5.9, 5.17, and 8.32 of the Farm Credit Act (12 U.S.C. 2154, 12 U.S.C. 2243, 12 U.S.C. 2252, and 12 U.S.C. 2279bb-1).

(b) Purpose. Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o-8) require the FCA to establish capital and margin requirements for any System institution, including the Federal Agricultural Mortgage Corporation, chartered under the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 et seq.) that is registered as a

swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statute's requirements.

(c) Scope. This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after **[insert date that is 180 days after publication of the final rule in the Federal Register**]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than are required under this part.

23. Paragraph (c) of § 624.2 is added to read as follows:

* * * * *

(c) Covered swap entity means any institution chartered under the Farm Credit Act of 1971, as amended (12 U.S.C. 2001 et seq.) that is a swap entity, or any other entity that the FCA determines.

* * * * *

24. Section 624.10 is added to read as follows:

§ 624.10 Capital requirement.

A covered swap entity shall comply with:

(a) In the case of the Federal Agricultural Mortgage Corporation, the capital adequacy regulations set forth in 12 CFR Part 652; and

(b) In the case of any Farm Credit System institution other than the Federal Agricultural Mortgage Corporation, the capital regulations set forth in 12 CFR Part 615.

25. Section 624.11 is added to read as follows:

§ 624.11 Special requirements for transactions between swap entities and System institutions.

(a) Margin requirements. To the extent that a System institution, including the Federal Agricultural Mortgage Corporation, that is not a covered swap entity enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the System institution shall:

(1) Collect initial margin from the swap entity in an amount and at such times as would be in accordance with the requirements of § 624.3, provided that for purposes of this § 624.10 any reference to "initial margin model" in the definition of "initial margin collection amount" shall mean:

(i) The System institution's initial margin model, if any, or

(ii)(A) If the System institution does not have an initial margin model, an initial margin model used by a third party to calculate initial margin on behalf of the System institution in accordance with § 624.3, provided that the third party is itself independent of the swap entity that is the counterparty in the transaction at issue.

(B) The amounts of initial margin collected under this paragraph may be adjusted for minimum transfer amounts as allowed under § 624.3(c).

(2) Collect variation margin daily from the swap entity in an amount that would be in accordance with the requirements in §§ 624.4(a) and 624.4(e). The amounts of variation margin collected under this paragraph may be adjusted as allowed for minimum transfer amounts under § 624.4(c) and for qualifying master netting agreements under § 624.4(d).

(b) Documentation. To the extent that a System institution enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the System institution shall execute trading

documentation with such swap entity in accordance with the requirements of § 624.5.

(c) Collateral. Any initial or variation margin that a System institution is required to collect from a swap entity under paragraph (a) of this section shall meet the eligible collateral requirements of § 624.6.

(d) Segregation. A System institution shall require that any funds or other property that it posts to a swap entity as initial or variation margin be held by a third-party custodian that is independent of the swap entity and the System institution, is located in a jurisdiction that applies the same insolvency regime to the third-party custodian as would apply to the System institution, and is subject to the rehypothecation, reinvestment, and other transfer restrictions of § 624.7

(e) Initial margin models. To the extent the initial margin collection amount that the System institution is required to collect from a swap entity under paragraph (a)(1) of this section is calculated by the System institution using an initial margin model, such model must meet all the requirements of § 624.8, provided that the appropriate prudential regulator responsible for making or rescinding any approvals to the extent required or allowed under § 624.8 shall be:

(1) In the case where the initial margin model is that of a third party that is subject to regulation by a prudential regulator, the prudential regulator having such jurisdiction; or

(2) In the case where the initial margin model is that of either the System institution or a third party that is not subject to regulation by a prudential regulator, the FCA.

FEDERAL HOUSING FINANCE AGENCY

List of Subjects
12 CFR Part 1221

Government-sponsored enterprises, Mortgages, Securities.

Authority and Issuance

For the reasons stated in the Supplementary Information, and under the authority of 7 U.S.C. 6s(e), 15 U.S.C. 78o-10(e), and 12 U.S.C. 4526, the Federal Housing Finance Agency proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 1221 of subchapter B of chapter XII of title 12 of the Code of Federal Regulations, modified as follows:

CHAPTER XII – FEDERAL HOUSING FINANCE AGENCY

SUBCHAPTER B – ENTITY REGULATIONS

PART 1221 —MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

26. The authority citation for part 1221 is added to read as follows:

Authority: 7 U.S.C. 6s(e), 15 U.S.C. 78o-10(e), 12 U.S.C. 4513 and 12 U.S.C. 4526(a).

27. Part 1221 is added as set forth at the end of the Common Preamble.

28. Part 1221 is amended by:

a. Removing “[Agency]” wherever it appears and adding in its place “FHFA”;
b. Removing “[The Agency]” wherever it appears and adding in its place “FHFA”; and
c. Removing “[capital metric]” wherever it appears and adding in its place “total capital”.

29. Section 1221.1 is added to read as follows:

§ 1221.1 Authority, purpose, and scope.

(a) Authority. This part is issued by the Federal Housing Finance Authority (FHFA) under section 4s(e) of the Commodity Exchange Act (7 U.S.C. 6s(e)), section 15F(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-10(e)), 12 U.S.C. 4513 and 12 U.S.C. 4526(a).

(b) Purpose. Section 4s of the Commodity Exchange Act (7 U.S.C. 6s) and section 15F of the Securities Exchange Act of 1934 (15 U.S.C. 78o-8) require FHFA to establish capital and margin requirements for any regulated entity that is registered as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant with respect to all non-cleared swaps and non-cleared security-based swaps. This regulation implements section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934 by defining terms used in the statute and related terms, establishing capital and margin requirements, and explaining the statute's requirements.

(c) Scope. This part establishes minimum capital and margin requirements for each covered swap entity subject to this part with respect to all non-cleared swaps and non-cleared security-based swaps. This part applies to any non-cleared swap or non-cleared security-based swap entered into by a covered swap entity on or after **[insert date that is 180 days after publication of the final rule in the Federal Register**]. Nothing in this part is intended to prevent a covered swap entity from collecting margin in amounts greater than is required under this part.

30. Section 1221.2 is amended as follows:

a. Add paragraph (c);

b. Redesignate paragraphs (z), (aa) and (bb) as paragraphs (bb), (cc), and (dd), respectively;

c. Redesignate paragraphs (u) through (y) as (v) through (z); and

d. Add new paragraphs (u) and (aa).

§ 1221.2 Definitions.

* * * * *

(c) Covered swap entity means any regulated entity that is a swap entity, or any other entity that FHFA determines.

* * * * *

(u) Regulated entity means any regulated entity as defined in section 1303(20) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4502(20)).

* * * * *

(aa) Total capital means:

(1) In the case of any Federal Home Loan Bank, "total capital" as such term is defined in 12 CFR 1229.1; and

(2) In the case of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or any of their respective affiliates, "total capital" as such term is defined in 12 CFR 1750.11.

* * * * *

31. Section 1221.10 is added to read as follows:

§ 1221.10 Capital .

A covered swap entity shall comply with the risk-based capital level or such other amount applicable to the covered swap entity as required by the Director of FHFA pursuant to 12 U.S.C. 4611.

32. Section 1221.11 is added to read as follows:

§ 1221.11 Special Requirements for Transactions Between Swap Entities and Regulated Entities.

(a) Margin Requirements. To the extent that a regulated entity that is not a covered swap entity enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the regulated entity shall:

(1) Collect initial margin from the swap entity in an amount and at such times as would be in accordance with the requirements of § 1221.3, provided that for purposes of this section any reference to "initial margin model" in the definition of "initial margin collection amount" shall mean:

(i) The regulated entity's initial margin model, if any, or

(ii)(A) If the regulated entity does not have an initial margin model, an initial margin model used by a third party to calculate initial margin on behalf of the regulated entity in accordance with § 1121.3, provided that the third party is itself independent of the swap entity that is the counterparty in the transaction at issue.

(B) The amounts of initial margin collected under this paragraph may be adjusted for minimum transfer amounts as allowed under § 1221.3(c).

(2) Collect variation margin daily from the swap entity in an amount that would be in accordance with the requirements in § 1221.4(a) and § 1221.4(e). The amounts of variation margin collected under this paragraph may be adjusted as allowed for minimum transfer amounts under § 1221.4(c) and for qualifying master netting agreements under § 1221.4(d).

(b) Documentation. To the extent that a regulated entity enters into a non-cleared swap or a non-cleared security-based swap with a swap entity, the regulated entity shall execute trading documentation with such swap entity in accordance with the requirements of § 1221.5.

(c) Collateral. Any initial or variation margin that a regulated entity is required to collect from a swap entity under paragraph (a) of this section shall meet the eligible collateral requirements of § 1221.6.

(d) Segregation. A regulated entity shall require that any funds or other property that it posts to a swap entity as initial or variation margin be held by a third-party custodian that is independent of the swap entity and the regulated entity, is located in a jurisdiction that applies the same insolvency regime to the third-party custodian as would apply to the regulated entity, and is subject to the rehypothecation, reinvestment, and other transfer restrictions of § 1221.7.

(e) Initial margin models. To the extent the initial margin collection amount that the regulated entity is required to collect from a swap entity under paragraph (a)(1) of this section is calculated by the regulated entity using an initial margin model, such model must meet all the requirements of § 1221.8, provided that the appropriate prudential regulator responsible for making or rescinding any approvals or taking other action to the extent required or allowed under § 1221.8 shall be:

(1) In the case where the initial margin model is that of a third party that is subject to regulation by a prudential regulator, the prudential regulator having such jurisdiction; or

(2) In the case where the initial margin model is that of either the regulated entity or a third party that is not subject to regulation by a prudential regulator, FHFA.

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES"]

Dated: April 11, 2011

John Walsh,
Acting Comptroller of the Currency.

BILLING CODE 4810-33-P

[THIS SIGNATURE PAGE RELATES TO THE JOINT NOTICE OF PROPOSED RULE ENTITLED "MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES"]

By order of the Board of Governors of the Federal Reserve System, April 12, 2011.

Jennifer J. Johnson,
Secretary of the Board.
BILLING CODE 6210-01-P

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES"]

Dated at Washington, D.C., this 12th of April 2011.
By order of the Board of Directors.
Federal Deposit Insurance Corporation.

Robert E. Feldman,
Executive Secretary

Billing Code: 6714–01–P

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES"]

Dated: April 11, 2011

Dale L. Aultman
Secretary,
Farm Credit Administration Board

Billing Code: 6705-01P

[THIS SIGNATURE PAGE RELATES TO THE PROPOSED RULE TITLED "MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES"]

Dated: April 11, 2011

Edward J. DeMarco,
Acting Director, Federal Housing Finance Agency.

Billing Code: 8070-01P

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[2] See 7 U.S.C. 1a(47); 15 U.S.C. 78c(a)(68). Swaps and security-based swaps are sometimes referred to herein collectively as "derivatives."

[3] See 7 U.S.C. 6s; 15 U.S.C. 78o-8. Section 731 of the Dodd-Frank Act requires swap dealers and major swap participants to register with the Commodity Futures Trading Commission (the "CFTC"), which is vested with primary responsibility for the oversight of the swaps market under title 7 of the Dodd Frank Act. Section 764 of the Dodd-Frank Act requires security-based swap dealers and major security-based swap participants to register with the Securities and Exchange Commission (the "SEC"), which is vested with primary responsibility for the oversight of the security-based swaps market under title 7 of the Dodd-Frank Act. Section 713(d)(1) of the Dodd-Frank Act requires the CFTC and SEC to issue joint rules further defining the terms swap dealer, major swap participant, security-based swap dealer, and major security-based swap participant. The CFTC and SEC issued a joint notice of proposed rulemaking with respect to these definitions in December, 2010. See 75 FR 80,174 (Dec. 21, 2010) (proposed rule).

[4] Section 1a(39) of the Commodities Exchange Act defines the term "prudential regulator" for purposes of the capital and margin requirements applicable to swap dealers, major swap participants, security-based swap dealers and major security-based swap participants. The Board is the prudential regulator for any swap entity that is (i) a State-chartered bank that is a member of the Federal Reserve System, (ii) a State-chartered branch or agency of a foreign bank, (iii) a foreign bank which does not operate an insured branch, (iv) an organization operating under section 25A of the Federal Reserve Act (an Edge corporation) or having an agreement with the Board under section 25 of the Federal Reserve Act (an Agreement corporation), and (v) a bank holding company, a foreign bank that is treated as a bank holding company under section 8(a) of the International Banking Act of 1978, or a savings and loan holding company (on or after the transfer date established under section 311 of the Dodd-Frank Act), or a subsidiary of such a company or foreign bank (other than a subsidiary for which the OCC or FDIC is the prudential regulator or that is required to be registered with the CFTC or SEC as a swap dealer or major swap participant or a security-based swap dealer or major security-based swap participant, respectively). The OCC is the prudential regulator for any swap entity that is a national bank, a federally chartered branch or agency of a foreign bank, or a Federal savings association. The FDIC is the prudential regulator for any swap entity that is (i) a State-chartered bank that is not a member of the Federal Reserve System or (ii) a State savings association. The FCA is the prudential regulator for any swap entity that is an institution chartered under the Farm Credit Act of 1971, as amended. FHFA is the prudential regulator for any swap entity that is a "regulated entity" under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (i.e., the Federal National Mortgage Association and its affiliates, the Federal Home Loan Mortgage Corporation and its affiliates, and the Federal Home Loan Banks). See 7 U.S.C. 1a(39).

[5] See 7 U.S.C. 6s(e)(2)(A); 15 U.S.C. 78o-8(e)(2)(A). Section 6(s)(e)(1)(A) directs registered swap dealers and major swap participants for which there is a prudential regulator to comply with margin and capital rules issued by the prudential regulators, while section 6(s)(e)(1)(B) directs registered swap dealers and major swap participants for which there is not a prudential regulator to comply with margin and capital rules issued by the CFTC and SEC. Section 78o-8(e)(1) generally parallels section 6s(e)(1), except that section 78o-8(e)(1)(A) refers to registered security-based swap dealers and major security-based swap participants for which "there is not a prudential regulator." The Agencies construe the "not" in section 78o-8(e)(1)(A) to have been included by mistake, in conflict with section 78o-8(e)(2)(A), and of no substantive meaning. Otherwise, registered security-based swap dealers and major security-based swap participants for which there is not a prudential regulator could be subject to multiple capital and margin rules, and institutions regulated by the prudential

regulators and registered as security-based swap dealers and major security-based swap participants might not be subject to any capital and margin requirements under section 78o-8(e).

[6] See 7 U.S.C. 6s(e)(2)(B); 15 U.S.C. 78o-8(e)(2)(B).

[7] See 7 U.S.C.§ 6s(e)(2)(A); 6s(e)(3)(D); 15 U.S.C.§ 78o-8(e)(2)(A), 78o-8(e)(3)(D). Staff of the Agencies have consulted with staff of the CFTC and SEC in developing the proposed rule.

[8] See 7 U.S.C. 6s(e)(3)(A); 15 U.S.C. 78o-8(e)(3)(A).

[9] See 7 U.S.C. 6s(e)(3)(A); 15 U.S.C. 78o-8(e)(3)(A). In addition, Section 1201 of Housing and Economic Recovery Act of 2008 (Pub. L. 110-289, 122 Stat. 2654) requires the Director of FHFA, when promulgating regulations relating to the Federal Home Loan Banks, to consider the following differences between the Federal Home Loan Banks and the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac): cooperative ownership structure; mission of providing liquidity to members; affordable housing and community development mission; capital structure; and joint and several liability. See section 1201 Pub. L. 110-289, 122 Stat. 2782-83 (amending 12 U.S.C. 4513). The Director of FHFA also may consider any other differences that are deemed appropriate. For purposes of this proposed rule, FHFA considered the differences as they relate to the above factors. FHFA requests comments from the public about whether differences related to these factors should result in any revisions to the proposal.

[10] See 7 U.S.C. 6s(e)(2)(C); 15 U.S.C. 78o-8(e)(2)(C). In addition, the margin requirements imposed by the Agencies must permit the use of noncash collateral, as the Agencies determine to be consistent with (i) preserving the financial integrity of the markets trading swaps and security-based swaps and (ii) preserving the stability of the U.S. financial system. See 7 U.S.C. 6s(e)(3)(C); 15 U.S.C. 78o -8(e)(3)(C).

[11] See Dodd Frank Act §§ 754, 774.

[12] See 7 U.S.C. 2(h); 15 U.S.C. 78c-3. Certain types of counterparties (e.g., counterparties that are not financial entities and are using swaps or security-based swaps to hedge or mitigate commercial risks) are exempt from this mandatory clearing requirement and may elect not to clear a swap or security-based swap that would otherwise be subject to the clearing requirement.

[13] G-20 Leaders, June 2010 Toronto Summit Declaration, ¶ 25. The dealer community has also recognized the importance of clearing–beginning in 2009, in an effort led by the Federal Reserve Bank of New York, the dealer community agreed to increase central clearing for certain credit derivatives and interest rate derivatives. See Press Release, Federal Reserve Bank of New York, New York Fed Welcomes Further Industry Commitments on Over-the-Counter Derivatives press release (June 2, 2009), available at www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html.

[14] CCPs interpose themselves between counterparties to a derivative transaction, becoming the buyer to the seller and the seller to the buyer and, in the process, taking on the credit risk that each party poses to the other. For example, when a derivatives contract between two parties that are members of a CCP is executed and submitted for clearing, it is typically replaced by two new contracts—separate contracts between the CCP and each of the two original counterparties. At that point, the original counterparties are no longer counterparties to each other; instead, each faces the CCP as its counterparty, and the CCP assumes the counterparty credit risk of each of the original counterparties.

[15] See proposed rule §§ __.2(b), (g), (h), (i), (n), (r) and (y) for the various constituent definitions that identify these four types of swap counterparties.

[16] Section __.11 of the proposed rule adopted by FHFA and FCA (but not the other Agencies) requires that their regulated entities collect initial and variation margin from swap entities, as described in section III.K of this notice.

[17] See proposed rule, Appendix A.

[18] See proposed rule §§ __.2(l), __.3(a), __.8.

[19] See proposed rule §§ __.2(m), __.3(a)(2).

[20] See proposed rule §§ __.2(z), __.4(a).

[21] See proposed rule §§ __.2(bb), __.4(a)(2).

[22] See proposed rule § __.4(b).

[23] See proposed rule § __.6.

[24] See proposed rule § __.7. The Agencies note that sections 724 and 763 of Dodd-Frank Act require a swap entity to offer its swap and security-based swap counterparties the option of requiring segregation of initial margin they post to the swap entity.

[25] 7 U.S.C. 6s(e)(2); 15 U.S.C. 78o-8(e)(2).

[26] See 54 FR 4186 (January 27, 1989). The general banking risk-based capital rules are codified at 12 CFR part 3, Appendix A (OCC); 12 CFR parts 208 and 225, Appendix A (Board); and 12 CFR part 325, Appendix A (FDIC).

[27] The Basel Committee on Banking Supervision (BCBS) developed the first international banking capital framework in 1988, entitled International Convergence of Capital Measurement and Capital Standards.

[28] 61 FR 47358 (September 6, 1996). The banking agencies' market risk capital rules are at 12 CFR part 3, Appendix B (OCC); 12 CFR part 208, Appendix E and 12 CFR part 225, Appendix E (Board); and 12 CFR part 325, Appendix C (FDIC). The rules apply to banks and bank holding companies with trading activity (on a worldwide consolidated basis) that equals 10 percent or more of the institution's total assets, or $1 billion or more.

[29] See BCBS, International Convergence of Capital Measurement and Capital Standards: A Revised Framework (2006). The banking agencies implemented the advanced approaches of the Basel II Accord in 2007. See 72 FR 69288 (December 7, 2010). The advanced approaches rules are codified at 12 CFR part 3, Appendix C (OCC); 12 CFR part 208, Appendix F and 12 CFR part 225, Appendix G (Board); and 12 CFR part 325, Appendix D (FDIC).

[30] See 53 FR 40.033 (Oct. 13, 1988); 70 FR 35.336 (June 17, 2005); 12 CFR Part 615 subpart H.

[31] See 66 FR 19,048 (April 12, 2001); 71 FR 77,247 (Dec. 26, 2006); 12 CFR Part 652.

[32] See BCBS, Basel III: A Global Regulatory Framework For More Resilient Banks and Banking Systems (2010), available at www.bis.org/publ.bcbs189.htm.

[33] For the duration of the conservatorships of Fannie Mae and Freddie Mac (together, the Enterprises), FHFA has directed that their existing regulatory capital requirements would not be binding. However, FHFA continues to closely monitor the Enterprises' activities. Such monitoring, coupled with the unique financial support available to the Enterprises from the United States Treasury and the likelihood that FHFA will promulgate new risk-based capital rules in due course to apply to the Enterprises (or their successors) once the conservatorships have ended, lead to FHFA's preliminary view that the reference to existing capital rules is sufficient to address the risks discussed in the text above as to the Enterprises.

[34] See proposed rule § __.8(b). The covered swap entity would not be permitted to selectively incorporate only certain pre-effective-date derivatives.

[35] Although the term "commercial end user" is not defined in the Dodd-Frank Act, it is generally understood to mean a company that is eligible for the exception to the mandatory clearing requirement for swaps and security-based swaps under section 2(h)(7) of the Commodity Exchange Act and section 3C(g) of the Securities Exchange Act, respectively. This exception is generally available to a person that (i) is not a financial entity, (ii) is using the swap to hedge or mitigate commercial risk, and (iii) has notified the CFTC or SEC how it generally meets its financial obligations with respect to non-cleared swaps or security-based swaps, respectively. See 7 U.S.C. 2(h)(7) and 15 U.S.C. 78c-3(g).

[36] See, e.g., 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement of Sen. Lincoln).

[37] In the case of a nonfinancial end user with a strong credit profile, under current market practices a derivatives dealer would not require margin—in essence, it would extend unsecured credit to the end user with respect to the underlying exposure. For counterparties with a weak credit profile, a derivatives dealer would likely make a different credit decision and require the counterparty to post margin.

[38] See proposed rule § __.2(y).

[39] This is consistent with the Dodd Frank Act's requirement that the Agencies set margin and capital requirements appropriate for the risk to the financial system associated with non-cleared swaps held as a swap dealer or major swap participant. 7 U.S.C. 6(e)(3)(A); 15 U.S.C. 78o-8(e)(3)(A).

[40] Although the proposed rule does not define a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company of 1956 (12 U.S.C. 1843(k)), the Agencies note that the Board has recently issued a proposed rule for comment defining a similar term for purposes of Title I of the Dodd-Frank Act. See 76 FR 7,731 (Feb. 11, 2011) (proposed rule). The Agencies request comment on whether they should apply the same methodology as is adopted for purposes of Title I of the Dodd-Frank Act for purposes of this clause of the proposed rule's definition of a financial end user, or whether an alternative methodology is appropriate.

[41] See proposed rule § __.2(h). This definition of "financial end user" is based upon, and substantially similar to, the definition of a "financial entity" that is ineligible to use the end user exemption from the mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act. See 7 U.S.C. 2(h)(7); 15 U.S.C. 78c-3(g).

[42] See proposed rule § __.2(h)(6).

[43] See proposed rule § __.2(n).

[44] See 75 FR 80,174 (Dec. 10, 2010).

[45] See 7 U.S.C. 1a(33)(A)(i)(I); 15 U.S.C. 78c(a)(67)(a)(ii)(I).

[46] See 7 U.S.C. 1a(33)(A)(iii)(I); 15 U.S.C. 78c(a)(67)(a)(ii)(III)(aa).

[47] Separately, in the case of institutions regulated by FHFA and FCA, the effect of § __.11 of the proposed rule, when combined with the margin requirements contained in other parts of the proposed rule, would also be to effectively require both parties to a non-cleared swap or non-cleared security-based swap between a swap entity and an institution regulated by FHFA or FCA to both collect and post initial margin.

[48] See proposed rule §§ __.2(k)(1), __.3(a). Although the Agencies intend to specify a particular percentage in the final rule, the proposed rule provides a potential range of percentages for comment.

[49] See proposed rule §§ __.2(k)(2), __.3(a).

[50] See proposed rule §§ __.2(m), __.3(a). A covered swap entity that has established an initial margin threshold amount for a counterparty need only collect initial margin if the required amount exceeds the initial margin threshold amount, and in such cases is only required to collect the excess amount.

[51] See proposed rule § __.2(m)(1).

[52] See proposed rule § __.2(m).

[53] Although the Agencies intend to specify particular amounts in the final rule, the proposed rule provides a potential range of numbers for comment. Since tier 1 capital is not a concept that is applicable to covered swap entities for which FHFA or the FCA is the prudential regulator, the thresholds as applied to such entities instead reference (i) in the case of covered swap entities for which FHFA is the prudential regulator, the term "total capital," as separately defined within the proposed regulatory text of FHFA's proposed rule, and (ii) in the case of covered swap entities for which the FCA is the prudential regulator, the term "applicable core surplus or core capital (or successor high quality capital requirement)," as separately defined within the proposed regulatory text

of the FCA's proposed rule.

[54] The Agencies also note that the categories of counterparties for which the proposed rule permits a covered swap entity to establish an initial margin threshold amount are roughly aligned with the Dodd-Frank Act exemption of non-financial end users from the Dodd-Frank Act mandatory clearing requirement. See 7 U.S.C. 2(h)(7); 15 U.S.C. 78c-3(g).

[55] See proposed rule § __.3(c). The minimum transfer amount only affects the timing of margin collection; it does not change the amount of margin that must be collected once the $100,000 threshold is crossed. For example, if the initial margin requirement were to increase from $50,000 to $110,000, the covered swap entity would be required to collect the entire $110,000 (subject to application of any applicable initial margin threshold amount).

[56] As described in section III.K of this notice, FHFA's and the FCA's proposed rules contain an additional provision that will have a different effect with respect to entities regulated by FHFA and the FCA.

[57] See proposed rule § __.4(a).

[58] The proposed rule defines this required amount as the "variation margin amount." See proposed rule § __.2(bb). In the case of swap or security-based swap that is out-of-the-money or in-the-money to a covered swap entity at the time it enters into the transaction, that amount is also included within the definition of variation margin amount and subject to the variation margin requirements.

[59] See proposed rule §§ __.2(bb), __.4(a).

[60] See proposed rule § __.4(d).

[61] See proposed rule § __.2(t). The proposed rule's definition of qualifying master netting agreement generally mirrors the definition given to that term in the Federal banking agencies' risk-based capital rules applicable to derivatives positions held by insured depository institutions and bank holding companies. See, e.g., 12 CFR 225, App. G.I.2.

[62] See proposed rule § __.4(e). The Agencies note that there is no similar reference to appropriate efforts in the proposed rule initial margin requirements; since initial margin is collected at the time a swap or security-based swap is entered into, a covered swap entity can and must collect any required initial margin as prerequisite to executing the transaction

[63] See proposed rule § __.5.

[64] See id.

[65] See proposed rule § _6(a). An obligation will be considered to be fully guaranteed as to principal and interest by the United States if the guarantee commits the full faith and credit of the United States for the repayment of principal and interest on the obligation. "Insured obligations" of Farm Credit System banks are consolidated and System-wide obligations issued by Farm Credit System banks. These obligations are insured by the Farm Credit System Insurance Corporation out of funds in the Farm Credit Insurance Fund. Should the Farm Credit Insurance Fund ever be exhausted, Farm Credit System banks are jointly and severally liable for payment on insured obligations.

[66] See proposed rule § _6(b). With respect to these haircuts, although the Agencies intend to specify particular haircut amounts in the final rule, the proposed rule provides a potential range of haircuts for comment.

[67] See proposed rule § _6(d).

[68] See proposed rule § _6(c).

[69] See proposed rule § _7(a).

[70] See proposed rule §§ _7(b), (c).

[71] See proposed rule § _7(d).

[72] The proposed rule does not apply the segregation requirement to variation margin because

variation margin is generally used to offset the current exposure arising from actual changes in the market value of the derivative position, rather than to secure potential exposure arising from future changes in the market value of the derivative position. Under section __.11 of FHFA's and the FCA's proposed rules, entities regulated by FHFA and the FCA that are end users would have to require that any initial margin and variation margin they post to swap entities be segregated.

[73] For example, if dealer A and dealer B entered into a swap with each other under which each was required to collect $100 from the other in initial margin without segregation, each would collect $100 in initial margin from the other and no net initial margin would be exchanged. In the case of a bankruptcy of dealer B, dealer A would be permitted to set off the $100 loss that may be incurred in replacing the swap against the $100 in initial margin it "collected" from dealer B, but then would face the potential loss of the $100 in initial margin it provided to dealer B, for which it would only have a claim in bankruptcy. If instead the initial margin for such a swap had been segregated, dealer A would be permitted to set off the $100 loss that may incurred in replacing the swap against the $100 in initial margin that dealer B pledged to dealer A at a third-party custodian, and dealer A could also recover the $100 in initial margin that it pledged to dealer B at a third-party custodian, with the result that dealer A would incur no loss upon dealer B's bankruptcy.

[74] Although the agreements between the counterparties might not allow for requests for segregation after a swap transaction has been confirmed, as a practical matter counterparties might refuse to enter into any additional transactions with a financially-stressed swaps entity absent an accommodation to segregate some amount of initial margin for the existing portfolio of swaps between the two parties.

[75] This conservative approach also incorporates the practices associated with model validation, independent review and other qualitative requirements associated with the use of internal models for regulatory capital purposes.

[76] See proposed rule § __.8(d)(1).

[77] See proposed rule § __.8(b).

[78] Id.

[79] See proposed rule § __.8(d)(11).

[80] See proposed rule § __.8(d)(14).

[81] Section 2(i) of the Commodity Exchange Act, as amended by section 722 of the Dodd-Frank Act, provides that the provisions of the Commodity Exchange Act relating to swaps "shall not apply to activities outside of the United States unless those activities … have a direct and significant connection with activities in, or effect on, commerce of the United States."

[82] See proposed rule § __.9(a).

[83] See proposed rule § __.9(b).

[84] Under the proposed rule, swap and security-based swaps with U.S. counterparties are subject to the proposed rule's margin requirements regardless of whether the covered swap entity is U.S. or foreign.

[85] See proposed rule § __.9(c).

[86] See proposed rule § __.10.

[87] For example, under the banking agencies' capital adequacy standards for banks and bank holding companies based on the first Basel Accord, interest-rate, exchange-rate, commodity, and equity-linked derivative contracts that are not traded on an exchange are subject to a capital charge based on type of contract, remaining maturity, and the risk category of the counterparty to the contract. See 12 CFR part 3, Appendix A § 3(b)(7) (OCC); 12 CFR parts 208 and 225, Appendix A § III.E (Board); 12 CFR part 325, Appendix A § II.E (FDIC). As another example, under the bank agencies' advanced risk-based capital adequacy standards based on the advanced approaches of the Basel II Accord ("advanced approaches"), banks and bank holding companies that use the advanced approaches determine capital requirements for over-the-counter derivatives based on a formula that

takes into account collateral in mitigating counterparty credit risk. See 12 CFR part 3, Appendix C, part IV (OCC); 12 CFR part 208, Appendix F, part IV and 12 CFR part 225, Appendix G, part IV (Board); and 12 CFR part 325, Appendix D, part IV (FDIC). The FCA's capital requirements for FCS institutions other than Farmer Mac expressly address derivatives transactions. See 12 CFR 615.5201 and 615.5212. The FCA's capital requirements for Farmer Mac indirectly address derivatives transactions in the operational risk component of the statutorily mandated risk-based capital stress test model. See 12 CFR Part 652 Subpart B Appendix A. The FCA, through the Office of Secondary Market Oversight, closely monitors and supervises all aspects of Farmer Mac's derivatives activities, and the FCA believes existing requirements and supervision are sufficient to ensure safe and sound operations in this area. However, the FCA is considering enhancements to the model and in the future may revise the model to more specifically address derivatives transactions.

[88] See footnote 33, supra, for a discussion of the basis for FHFA's preliminary view that the reference to existing statutory authority is sufficient to address the risks discussed in the text above as to the Enterprises notwithstanding their current conservatorship status.

[89] See FCA and FHFA proposed rule § __.11. FCA and FHFA note that in sections III.C and III.D of this notice of proposed rulemaking, the Agencies have requested comment on alternative approaches to margin requirements, including whether covered swap entities should be required to post margin to end users. In the event such an alternative approach is adopted as part of a final rule, as to both initial and variation margin requirements, FCA and FHFA note that this proposed § __.11 may not need to be adopted as part of that final rule.

[90] See 12 U.S.C.§ 2154, 2248, 2252, 4513, 4526.

[91] U.S. Small Business Administration, Table of Small Business Size Standards Matched to North American Industry Classification System Codes, available at www.sba.gov/sites/default/files/Size_Standards_Table.pdf.

76 FR 37029, 06/24/2011

Handbook Mailing HM-11-8

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 45
Docket No. OCC-2011-0008
RIN: 1557-AD43

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
12 CFR Part 237
Docket No. R-1415
RIN: 7100 AD74

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 324
RIN: 3064-AD79

FARM CREDIT ADMINISTRATION
12 CFR Part 624
RIN: 3052-AC69

FEDERAL HOUSING FINANCE AGENCY
12 CFR Part 1221
RIN: 2590-AA45

MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Farm Credit Administration (FCA); and the Federal Housing Finance Agency (FHFA).

ACTION: Proposed rule; extension of comment period.

SUMMARY: On May 11, 2011, the OCC, Board, FDIC, FCA, and FHFA (collectively, the Agencies) published in the Federal Register a joint notice of proposed rulemaking for public comment to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the Agencies is the prudential regulator (the proposed rule).

Due to the complexity of the rulemaking, to allow parties more time to consider the impact of the proposed rule, and so that the comment period on the proposed rule will run concurrently with the comment period for similar margin and capital requirements proposed by the Commodity Futures Trading Commission, the Agencies have determined that an extension of the comment period until July 11, 2011 is appropriate. This action will allow interested persons additional time to analyze the proposed rules and prepare their comments.

DATES: Comments on the proposed rule must be received on or before July 11, 2011.

ADDRESSES: You may submit comments by any of the methods identified in the proposed rule. Please submit your comments using only one method.

FOR FURTHER INFORMATION CONTACT:

OCC: Michael Sullivan, Director, Market RAD (202) 874-3978, Kurt Wilhelm, Director, Financial Markets Group (202) 874-4479, Jamey Basham, Assistant Director, Legislative and Regulatory Activities Division (202) 874-5090, or Ron Shimabukuro, Senior Counsel, Legislative and Regulatory Activities Division (202) 874-5090, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

Board: Sean D. Campbell, Deputy Associate Director, Division of Research and Statistics, (202) 452-3761, Michael Gibson, Senior Associate Director, Division of Research and Statistics, (202) 452-2495, or Jeremy R. Newell, Senior Attorney, Legal Division, (202) 452-3239, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington , D.C. 20551.

FDIC: Bobby R. Bean, Chief, Policy Section, (202) 898-6705, John Feid, Senior Capital Markets Specialist, (202) 898-8649, Division of Risk Management Supervision, Thomas F. Hearn, Counsel, (202) 898-6967, or Ryan K. Clougherty, Senior Attorney, (202) 898-3843, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

FHFA: Robert Collender, Principal Policy Analyst, Office of Policy Analysis and Research, 202-343-1510, Robert.Collender@fhfa.gov, Peggy Balsawer, Assistant General Counsel, Office of General Counsel, 202-343-1529, Peggy.Balsawer@fhfa.gov, or James Carley, Senior Associate Director, Division of FHLBank Regulation, 202-408-2507, James.Carley@fhfa.gov, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877-8339.

FCA: William G. Dunn, Acting Associate Director, Finance and Capital Markets Team, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434, Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4434, or Rebecca S. Orlich, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

On May 11, 2011, the proposed rule was published in the Federal Register.[1] The proposed rule would establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the Agencies is the prudential regulator, as required under sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).[2] Sections 731 and 764 of the Dodd-Frank Act add a new section 4s to the Commodity Exchange Act and a new section 15F to the Securities Exchange Act of 1934, respectively, which require the registration and regulation of swap dealers and major swap participants and security-based swap dealers and major security-based swap participants (collectively, swap entities). For certain types of swap entities that are prudentially regulated by one of the Agencies, sections 731 and 764 of the Dodd-Frank Act require the Agencies to adopt rules

jointly for swap entities under their respective jurisdictions imposing (i) capital requirements and (ii) initial and variation margin requirements on all non-cleared swaps and non-cleared security-based swaps. In recognition of the complexities of the rulemaking and the variety of considerations involved in its impact and implementation, the Agencies requested that commenters respond to numerous questions. The proposed rule stated that the public comment period would close on June 24, 2011.[3]

The Agencies have received requests from the public for an extension of the comment period.[4] The Agencies believe that it is important to allow parties more time to consider the impact of the proposed rule, and to extend the comment period on the proposed rule so that it will run concurrently with the comment period for similar margin and capital requirements proposed by the Commodity Futures Trading Commission.[5] Therefore, the Agencies are extending the deadline for submitting comments on the proposed rule from June 24, 2011 to July 11, 2011.

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[1] See 76 FR 27564.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law 111-203, 124 Stat. 1376 (2010).

[3] See id.

[4] See comment letter to the OCC, Board, and FDIC from American Bankers Association et al. (June 17, 2011).

[5] See 76 FR 23732; 76 FR 27621.

Dated: June 21, 2011

Julie L. Williams,
First Senior Deputy Comptroller and Chief Counsel

By order of the Board of Governors of the Federal Reserve System, acting through the Secretary under delegated authority, June 22, 2011.

Jennifer J. Johnson,
Secretary of the Board.

Dated at Washington, D.C., this 21 of June 2011.
Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary

Date: June 21, 2011

Dale L. Aultman
Secretary,
Farm Credit Administration Board.

June 21, 2011

Stephen M. Cross,
Deputy Director of the Division of Bank Regulation
By delegation
Federal Housing Finance Agency.

77 FR 60057, 10/02/2012

Handbook Mailing HM-12-7

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 45
Docket No. OCC-2011-0008
RIN: 1557-AD43

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
12 CFR Part 237
Docket No. R-1415
RIN: 7100 AD74
FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 324
RIN: 3064-AD79

FARM CREDIT ADMINISTRATION
12 CFR Part 624
RIN: 3052-AC69

FEDERAL HOUSING FINANCE AGENCY
12 CFR Part 1221
RIN: 2590-AA45

Margin and Capital Requirements for Covered Swap Entities; Reopening of Comment Period

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Farm Credit Administration (FCA); and the Federal Housing Finance Agency (FHFA).

ACTION: Reopening of comment period for proposed rule.

SUMMARY: The OCC, Board, FDIC, FCA, and FHFA (collectively, the Agencies) are reopening the comment period for the proposed rule published in the *Federal Register* on May 11, 2011 (76 FR 27564) to establish minimum margin and capital requirements for uncleared swaps and security-based swaps entered into by swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the Agencies is the prudential regulator (Proposed Margin Rule). Reopening the comment period that expired on July 11, 2011 will allow interested persons additional time to analyze and comment on the Proposed Margin Rule in light of the consultative document on margin requirements for non-centrally-cleared derivatives recently published for comment by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO).

DATES: Comments must be received on or before November 26, 2012.

ADDRESSES: Interested parties are encouraged to submit written comments jointly to all of the

Agencies. Commenters are encouraged to use the title "Margin and Capital Requirements for Covered Swap Entities" to facilitate the organization and distribution of comments among the Agencies. Commenters are also encouraged to identify the number of the specific question for comment to which they are responding.

Office of the Comptroller of the Currency : Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or e-mail, if possible. Please use the title "Margin and Capital Requirements" to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- *Federal eRulemaking Portal – "Regulations.gov"* : Go to http://www.regulations.gov. Select "Document Type" of "Proposed Rules," and in the "Enter Keyword or ID Box," enter Docket ID "OCC-2011-0008," and click "Search." On "View By Relevance" tab at the bottom of screen, in the "Agency" column, locate the Proposed Rule for the OCC, in the "Action" column, click on "Submit a Comment" or "Open Docket Folder" to submit or view public comments and to view supporting and related materials for this rulemaking action.

- Click on the "Help" tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket after the close of the comment period.

- *E-mail* : regs.comments@occ.treas.gov.

- *Mail* : Office of the Comptroller of the Currency, 250 E Street, SW, Mail Stop 2-3, Washington, DC 20219.

- *Fax* : (202) 874-5274.

- *Hand Delivery/Courier* : 250 E Street, SW, Mail Stop 2-3, Washington, DC 20219.

Instructions: You must include "OCC" as the agency name and "Docket ID OCC-2011-0008" in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, e-mail addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

You may review comments and other related materials that pertain to this proposed rulemaking by any of the following methods:

- *Viewing Comments Electronically* : Go to http://www.regulations.gov. Select "Document Type" of "Public Submissions," and in the "Enter Keyword or ID Box," enter Docket ID "OCC-2011-0008," and click "Search." Comments will be listed under "View By Relevance" tab at the bottom of screen. If comments from more than one agency are listed, the "Agency" column will indicate which comments were received by the OCC.

- *Viewing Comments Personally* : You may personally inspect and photocopy comments at the

OCC, 250 E Street, SW, Washington, DC 20219. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874-4700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.

- *Docket* : You may also view or request available background documents and project summaries using the methods described above.

Board of Governors of the Federal Reserve System: You may submit comments, identified by Docket No. R-1415 and RIN 7100 AD74, by any of the following methods:

- *Agency Web Site* : http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.

- *Federal eRulemaking Portal:* http://www.regulations.gov. Follow the instructions for submitting comments.

- *E-mail:* regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.

- *Fax:* (202) 452-3819 or (202) 452-3102.

- *Mail:* Address to Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

All public comments will be made available on the Board's web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW) between 9:00 a.m. and 5:00 p.m. on weekdays.

Federal Deposit Insurance Corporation : You may submit comments, identified by RIN3064 AD-79 , by any of the following methods:

- *Agency Web Site* : http://www.fdic.gov/regulations/laws/federal/propose.html. Follow instructions for submitting comments on the Agency Web Site.

- *E-mail* : Comments@FDIC.gov. Include the RIN number on the subject line of the message.

- *Mail* : Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.

- *Hand Delivery* : Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m.

Instructions : All comments received must include the agency name and RIN for this rulemaking and will be posted without change to http://www.fdic.gov/regulations/laws/ federal/propose.html, including any personal information provided.

Farm Credit Administration : We offer a variety of methods for you to submit your comments. For

accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comments multiple times via different methods. You may submit comments by any of the following methods:

- *E-mail* : Send us an e-mail at reg-comm@fca.gov.

- *FCA Web site* : http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."

- *Federal eRulemaking Portal* : http://www.regulations.gov. Follow the instructions for submitting comments.

- *Mail* : Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

Federal Housing Finance Agency: You may submit your written comments on the proposed rulemaking, identified by regulatory information number (RIN) 2590-AA45, by any of the following methods:

- *E-mail* : Comments to Alfred M. Pollard, General Counsel, may be sent by e-mail at RegComments@fhfa.gov. Please include "RIN 2590-AA45" in the subject line of the message.

- *Federal eRulemaking Portal* : http://www.regulations.gov. Follow the instructions for submitting comments. If you submit your comment to the *Federal eRulemaking Portal* , please also send it by e-mail to FHFA at RegComments@fhfa.gov to ensure timely receipt by the Agency. Please include ''RIN 2590-AA45" in the subject line of the message.

- *U.S. Mail, United Parcel Service, Federal Express, or Other Mail Service* : The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590-AA45, Federal Housing Finance Agency, Eighth Floor, 400 Seventh Street, SW, Washington, DC 20024.

- *Hand Delivery/Courier* : The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590-AA45, Federal Housing Finance Agency, Eighth Floor, 400 Seventh Street, SW, Washington, DC 20024. The package should be logged at the Seventh Street entrance Guard Desk, First Floor, on business days between 9:00 a.m. and 5:00 p.m.

All comments received by the deadline will be posted for public inspection without change, including any personal information you provide, such as your name, address (mailing or email), and telephone numbers, on the FHFA website at http://www.fhfa.gov. Copies of all comments timely received will be available

for public inspection and copying at the address above on government-business days between the hours of 10:00 a.m. and 3:00 p.m. To make an appointment to inspect comments please call the Office of General Counsel at (202) 649-3804.

FOR FURTHER INFORMATION CONTACT:

OCC: Jamey Basham, Assistant Director, Legislative and Regulatory Activities Division (202) 874-5090, Marvin Shaw, Counsel, Ron Shimabukuro, Senior Counsel, Legislative and Regulatory Activities Division (202) 874-5090, or Kurt Wilhelm, Director, Financial Markets Group (202) 874-4479, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

Board : Sean D. Campbell, Deputy Associate Director, Division of Research and Statistics, (202) 452-3761; Jordan Bleicher, Division of Banking Supervision and Regulation, (202) 973-6123; or Christopher M. Paridon, Counsel, (202) 452-3274 or Anna M. Harrington, Attorney, (202) 452-6406, Legal Division, Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551.

FDIC : Bobby R. Bean, Associate Director, Capital Market Branch, (202) 898-6705, John Feid, Senior Policy Analyst, (202) 898-8649, Division of Risk Management Supervision, Thomas F. Hearn, Counsel, (202) 898-6967, or Ryan K. Clougherty, Senior Attorney, (202) 898-3843, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

FCA: William G. Dunn, Acting Associate Director, Finance and Capital Markets Team, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434, Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4434, or Rebecca S. Orlich, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

FHFA : Robert Collender, Principal Policy Analyst, Office of Policy Analysis and Research, (202) 649-3196, Robert.Collender@fhfa.gov, or Peggy Balsawer, Assistant General Counsel, Office of General Counsel, (202) 649-3060, Peggy.Balsawer@fhfa.gov, (not toll-free numbers), Federal Housing Finance Agency, 400 Seventh Street SW, Washington, DC 20024. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877-8339.

SUPPLEMENTARY INFORMATION:

I. Background

On May 11, 2011, the Agencies published in the *Federal Register* a notice of proposed rulemaking that would establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants for which one of the Agencies is the prudential regulator, as required under sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] Sections 731 and 764 of the Dodd-Frank Act add a new section 4s to the Commodity Exchange Act and a new section 15F to the Securities Exchange Act of 1934, respectively, which require the registration and regulation of swap dealers and major swap participants and security-based swap dealers and major security-based swap participants (collectively, swap entities). For certain types of swap entities that are prudentially regulated by one of the Agencies, sections 731 and 764 of the Dodd-Frank Act require the Agencies to adopt rules jointly for swap entities under their respective jurisdictions imposing: (i) Capital requirements and (ii)

initial and variation margin requirements on all non-cleared swaps and non-cleared security-based swaps.[2]

II. Reopening of Comment Period and Request for Comment

The original comment period to the Proposed Margin Rule closed on June 24, 2011.[3] In order to allow interested persons additional time to analyze the proposed rule and prepare their comments, the Agencies extended the comment period until July 11, 2011.[4] In the Proposed Margin Rule, the Agencies noted that applying the proposed margin requirements to transactions involving foreign swap entities or foreign counterparties could subject those transactions to multiple, and potentially conflicting, margin requirements established by U.S. and foreign regulators and could raise questions of competitive equality among U.S. and foreign firms. Margin standards that are developed and harmonized on an international basis could help address those issues.

In October 2011, the BCBS and IOSCO established a Working Group on Margin Requirements to develop harmonized international margin standards for non-cleared swaps. On July 6, 2012, BCBS and IOSCO published a Consultative Document entitled "Margin requirements for non-centrally-cleared derivatives" (Consultative Document) that outlines possible margin requirements for non-centrally-cleared derivatives.[5] The Consultative Document addresses a number of topics, including: (i) the instruments that would be subject to margin requirements; (ii) the market participants that would be subject to margin requirements; (iii) initial margin and variation margin methodology; (iv) eligible collateral; (v) treatment of provided margin; (vi) treatment of inter-affiliate transactions; and (vii) treatment of cross-border transactions.

BCBS and IOSCO are requesting comment on the initial proposals set forth in the Consultative Document by September 28, 2012. It is expected that, after reviewing and evaluating any comments received, the BCBS and IOSCO will issue final policy recommendations for margin requirements for non-centrally-cleared derivatives. As part of the international efforts to implement consistent global standards for non-centrally-cleared derivatives, the Agencies intend to consider the final policy recommendations set forth by the BCBS and IOSCO when adopting final U.S. rules for margin for non-cleared swaps.

Accordingly, the Agencies believe it is appropriate to reopen the comment period for the Proposed Margin Rule in order to give interested persons additional time to analyze the Proposed Margin Rule in light of the Consultative Document and an opportunity to comment on the Consultative Document and Proposed Margin Rule concurrently.[6]

Therefore, the Agencies are reopening the comment period until November 26, 2012, for all aspects of the Proposed Margin Rule.

Dated: September 25, 2012

Thomas Curry,
Comptroller of the Currency.
BILLING CODE 4810-33-P

By order of the Board of Governors of the Federal Reserve System, acting through the Secretary under delegated authority, September 18, 2012.

Robert deV. Frierson,
Secretary of the Board.
BILLING CODE 6210-01-P

Dated at Washington, D.C., this 29th of August 2012.
Federal Deposit Insurance Corporation.

Valerie J. Best
Assistant Executive Secretary
Billing Code: 6714–01–P

Date: September 7, 2012

Dale L. Aultman
Secretary,
Farm Credit Administration Board
Billing Code: 6705-01-P

Date: September 5, 2012

Edward J. DeMarco,
Acting Director,
Federal Housing Finance Agency
Billing Code: 8070-01-P

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[1]Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2]Sections 731 and 764 of the Dodd-Frank Act also require the Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC") to separately adopt rules imposing capital and margin requirements for swap entities for which there is no prudential regulator. *See* 7 U.S.C. 6s(e)(2)(B); 15 U.S.C. 78o-8(e)(2)(B). The Dodd-Frank Act requires the CFTC, SEC, and the Agencies to establish and maintain, to the maximum extent practicable, capital and margin requirements that are comparable, and to consult with each other periodically (but no less than annually) regarding these requirements. *See* 7 U.S.C. 6s(e)(2)(A); 6s(e)(3)(D); 15 U.S.C. 78o-8(e)(2)(A), 78o-8(e)(3)(D). Staff of the Agencies consulted with staff of the CFTC and SEC in developing the proposed rule.

[3]*See* 76 FR 27564 (May 11, 2011).

[4]*See* 76 FR 37029 (June 24, 2011).

[5] *See* BCBS and IOSCO, Margin requirements for non-centrally-cleared derivatives (July 6, 2012), available at www.bis.org/publ/bcbs226.pdf.

[6] On July 12, 2012, the CFTC reopened the comment period on its proposed margin rule under section 731 and 764 of the Dodd-Frank Act. See 76 FR 41109 (July 12, 2012).

76 FR 35138, 06/16/2011

Handbook Mailing HM-11-7

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 652

RIN 3052-AC70

Federal Agricultural Mortgage Corporation Funding and Fiscal Affairs; Farmer Mac Risk-Based Capital Stress Test, Version 5.0

AGENCY: Farm Credit Administration.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: In this advance notice of proposed rulemaking (ANPRM), the Farm Credit Administration (FCA, we, us, our) is requesting comments on alternatives to using credit ratings issued by nationally recognized statistical ratings organizations (NRSRO or credit rating agency) in regulations addressing the Risk-Based Capital Stress Test (RBCST or stress test) for the Federal Agricultural Mortgage Corporation (Farmer Mac or FAMC). Recent legislation requires every Federal agency to remove any references to credit ratings from its regulations and to substitute them with other standards of creditworthiness considered appropriate. Additionally, in response to this same legislative emphasis on ensuring appropriate prudential oversight of derivatives transactions, we are considering whether the RBCST should include a more explicit and comprehensive capital charge for counterparty risk stemming from derivative transactions. Lastly, through the ANPRM we are seeking public input on how we might revise the operational and strategic business planning requirements for FAMC to place greater emphasis on diversity and inclusion.

DATES: You may send comments on or before August 15, 2011.

ADDRESSES: We offer a variety of methods for you to submit comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we no longer accept comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters", then "Public Comments", and follow the directions for "Submitting a Comment".
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Laurie A. Rea, Director, Office of Secondary Market Oversight, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia, or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters", then "Public Comments", and follow the directions for "Reading Submitted Public Comments". We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4434,

Or

Laura McFarland, Senior Counsel, Office of the General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objective

The purpose of this ANPRM is to gather public input on how FCA might:

- Revise existing Farmer Mac RBCST regulations to replace data from credit rating agencies.
- Comprehensively address derivative counterparty exposure in the RBCST; and
- Revise operational and strategic business planning requirements to place greater emphasis on diversity and inclusion.

II. Background

Farmer Mac is an institution of the Farm Credit System, regulated by FCA through the FCA Office of Secondary Market Oversight (OSMO). Farmer Mac was established and chartered by Congress to create a secondary market for agricultural real estate mortgage loans, rural housing mortgage loans, and rural utilities loans, and it is a stockholder-owned instrumentality of the United States. Title VIII of the Farm Credit Act of 1971, as amended, (Act) governs Farmer Mac.[1]

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) was enacted.[2] Section 939A of the Dodd-Frank Act requires Federal agencies to review all regulatory references to NRSRO credit ratings and replace those references with other appropriate standards for determining creditworthiness. The Dodd-Frank Act further provides that, to the extent feasible, agencies should adopt a uniform standard of creditworthiness for use in regulations, taking into account the entities regulated and the purposes for which such regulated entities would rely on the creditworthiness standard.

The FCA uses credit rating agency data in its RBCST regulations for Farmer Mac. Section 8.32 of the Act required FCA to establish a risk-based capital stress test for Farmer Mac's portfolio.[3] This

stress test determines the level of regulatory capital necessary for Farmer Mac to maintain positive capital during a 10-year period where stressful credit and interest rate conditions occur. We first published regulations on the stress test, and other requirements related to section 8.32 of the Act, in the Federal Register at 66 FR 19048 (April 12, 2001). Since then, we revised the stress test several times, most recently to capture capital requirements for Farmer Mac's rural utilities authorities. The existing RBCST for Farmer Mac is contained in 12 CFR part 652, subpart B, and it currently relies, in part, on NRSRO credit ratings when calculating regulatory minimum capital requirements.

We have comprehensively reviewed our regulations that use or rely on credit ratings, including other sections in part 652 which govern Farmer Mac's non-program investments and liquidity reserve requirements. This ANPRM is one of several notices and proposed rules on which we will be seeking public input relating to use of credit ratings in our rules.

A. Farmer Mac Programs

Under the Farmer Mac I program, FAMC guarantees prompt payment of principal and interest on securities representing interests in, or obligations backed by, mortgage loans secured by first liens on agricultural real estate or rural housing. It also purchases, or commits to purchase, qualified loans or securities backed by qualified loans directly from lenders. Under the Farmer Mac II program, FAMC purchases and securitizes portions of certain loans guaranteed by the U.S. Department of Agriculture, including farm ownership and operating loans and rural business and community development loans. Farmer Mac also guarantees the timely payment of principal and interest on the securities created from these loans. In 2008, Congress granted Farmer Mac the authority to purchase and guarantee securities backed by loans to rural electric and telephone utility cooperatives as program business.[4] Farmer Mac also provides a secondary market for USDA-guaranteed farm program and rural development loans.

B. Risk-based Capital and Credit Ratings

Under our rules, Farmer Mac's regulatory capital must be sufficient so that it would remain positive during the 10-year time horizon of the stress test. One component of the RBCST accounts for the risk of loss on specific types of program investments (i.e., investments backed by agricultural real estate mortgage loans, rural housing loans, or rural utility cooperative loans) that include credit enhancement features. In this context, credit risk is adjusted downward based on the whole-letter credit rating of the counterparty on AgVantage and similarly structured assets. The adjustment is made to recognize the risk-reducing strength of the counterparty's general obligation backing of these securities. These securities are further backed by eligible loan collateral.

Another component of the RBCST estimates counterparty risk associated with non-program investments, e.g., corporate debt, asset-backed securities and mortgage- related securities. In this context, the RBCST reduces earnings at rates related to the cumulative historical default and recovery rates of corporate debt by whole-letter credit rating category as published by Moody's Investor Services.[5] The RBCST's calculations in each of these two components use five whole-letter rating categories. It then assigns counterparties into these categories by referencing ratings issued by an NRSRO for the counterparty. The regulations, in turn, specify the change in expected cash flows during the stress period to reflect the risk of default by a counterparty based in part on the assigned ratings category. The changes in cash flows decrease projected losses on program assets and decrease earnings on non-program investments, which then translate to changes in equity over the modeling horizon and affect the required minimum regulatory capital calculated by the stress test.

FCA initially chose to use NRSRO ratings in the RBCST as a source of objective and neutral

third-party assessments of the credit risk for particular instruments and counterparties. We used ratings because they were readily and publicly available. The use of NRSRO ratings was also, at the time, believed to offer enhanced consistency in credit evaluation across different components of the RBCST. In 2010, the Dodd-Frank Act addressed, in part, the structure of credit rating agencies, requiring revisions and imposing other requirements in an effort to resolve the conflicts of interest and other difficulties believed to be at the center of the 2008-2009 financial market crisis. The Dodd-Frank Act also questioned the value of these ratings when used as the primary data source in the assessment of the creditworthiness of a security or money market instrument. In connection with that, the Dodd-Frank Act requires every Federal agency to remove any reference to, or reliance on, credit rating agencies in its regulations and replace any such reference with an alternative standard of credit worthiness considered appropriate for the regulatory purpose. As a result, we are seeking suggestions on what alternative data sources would be most appropriate for the RBCST.

C. Considerations and Objectives for a New Approach to Quantifying Relative Creditworthiness

FCA believes that any new standard of creditworthiness should distinguish between different levels of credit risk, in an accurate and timely manner, and be transparent in its approach. We believe it should also be applied consistently across the multiple components of the RBCST and be reasonably simple, while not unduly burdensome to apply and not be easily subject to manipulation. FCA recognizes that any resulting system will likely involve trade-offs among these objectives, e.g., simple versus accurate and timely, accurate and timely versus not burdensome to apply.

To eliminate the use of NRSRO ratings in calculating risk-based capital requirements for Farmer Mac, we need to develop an alternative basis to assess counterparty risk. One approach may be to identify objective criteria that Farmer Mac could apply to categorize credit exposures into different risk classes and assess counterparty risk accordingly. The criteria may be broadly designated. For example, credit exposures could be divided into government and non-government, secured and unsecured, or other categories, such as maturity. Such a broad approach, however, may not be able to sufficiently and consistently account for difference in relative risk among exposures that fall into the same category. FCA may also consider adopting criteria that reference certain financial or other metrics related to the obligor or counterparty. To be meaningful, the criteria would need to account for or bear a reasonable correlation to the potential riskiness of default among different obligors or counterparties. Any criteria would also need to be readily obtainable for all relevant counterparties by FCA, Farmer Mac and the public or it might not be sufficiently transparent and objective. The standards would need to ensure that the investment or position is not speculative, and carries credit risk appropriate for Farmer Mac's risk profile and the authorized purposes for non-program investments. As any new counterparty risk evaluation approach is initiated, there is the potential for increased risk as the new system is implemented.

FCA might also consider an approach that builds on Farmer Mac's internal credit review process and allows it to assign risk ratings to various categories and assess risk based on qualitative and quantitative standards set by FCA regulations. For example, FCA could assign loss rate estimates based on Farmer Mac's internal ratings or some modification of such, as reviewed or approved by FCA – or simply review or approve Farmer Mac's mapping of its assigned risk ratings to estimated loss rates. This approach would be more subjective than the alternative discussed above but could allow FCA to leverage the data collection and analysis already performed by Farmer Mac. Under this approach, FCA would likely rely heavily on the supervisory process to make sure that Farmer Mac is strictly following its internal guidelines and not assuming high levels of credit risk.

Questions (1) through (11) of Section III of this ANPRM address this topic.

D. Counterparty Risk on Derivatives

As part of our Dodd-Frank Act review and the increasing emphasis by the financial industry on ensuring appropriate prudential oversight of derivatives transactions, we are also considering whether the RBCST should include a more explicit and comprehensive capital charge for counterparty risk stemming from derivative transactions.

The RBCST produces a single comprehensive capital requirement for Farmer Mac by modeling changes in cash flows under a specific statutory stress scenario. We believe there may be opportunities to revise the RBCST to add a representation of counterparty default exposure on derivatives transactions by considering both net replacement cost as well as current exposure to individual cash flows based on an assessment of the counterparty's creditworthiness.

Questions (12) and (13) of Section III. of this ANPRM address this topic.

E. Capital and Business Planning

As part of this ANPRM, we are seeking input on how we might revise § 652.60(b) on operational and strategic business planning requirements to place greater emphasis on diversity and inclusion in both Farmer Mac's personnel as well as the borrowers and lenders who benefit from its secondary market activities.

We believe an integral part of promoting and achieving inclusion and diversity can be accomplished through an effective operational plan that includes strategies to seek out qualified loans from a diverse group of sources and provides rural lenders with financing products that serve a diverse array of borrowers, such as small, beginning, new, disabled, female, and minority farmers, ranchers, and rural homeowners, as well as cooperatives with diversity of ownership. We believe promotion of inclusion and diversity should also extend to non-traditional agricultural producers, such as local food systems, organic or specialty crop farmers, and community-supported agriculture.

Additionally, we are considering whether Farmer Mac's operational and strategic plans should include strategies and actions to achieve diversity and inclusion within FAMC's workforce, management, and governance structure, as well as an assessment of the progress FAMC has made in this area. We are also contemplating whether the plans should describe FAMC's succession programs.

Questions (14) and (15) of Section III. of this ANPRM address this topic.

III. Request for Comments

FCA regulations governing the Farmer Mac RBCST contain specific references to credit ratings issued by NRSROs for purposes of calculating regulatory minimum capital requirements. FCA is issuing this ANPRM to identify standards that may be appropriate replacements for credit ratings issued by NRSROs, which maintain compliance with statutory design requirements for the RBCST. Other regulatory agencies have also issued ANPRMs as part of their process to address references to credit ratings in their capital regulations and prudential standards.[6] We encourage any interested person(s) to submit comments on the following questions and ask that you support your comments with relevant data or examples. We remind commenters that comments and data submitted in support of a comment are available to the public through our rulemaking files.

1. What core principles would be most important in FCA's development of new standards of creditworthiness?

2. What qualitative and quantitative standards would FCA need to set to implement an approach that relied on the Farmer Mac to generate internal estimates of counterparty risk exposures? What are the strengths and weaknesses of such an approach?

3. Is it important that FCA's approach to replacing its reliance on credit rating agency data be consistent with that of other financial regulators or with those of other Farm Credit System institutions? If so, how important and why?

4. What specific creditworthiness or investment criteria should FCA use in its RBCST regulation?

5. What types of objective criteria should be used to differentiate credit exposures and apply meaningful counterparty risk estimates in the RBCST?

6. Should different criteria be used for different broad classes of investments or exposures? If so, what perverse incentives or other unintended consequences could that lead to? For example, could criteria that are perceived to be more flexible or subjective for a given asset class incent the regulated entity to accept a proportion of exposure to that asset class relative to its entire program (or non-program) portfolio that it might deem excessive without that incentive?

7. What approach would estimate a meaningful and consistent level of counterparty risk for a variety of exposures by employing publicly available qualitative and quantitative metrics, such as individual obligor credit spreads and/or financial ratio analysis to estimate probability of default and recovery rates?

8. Alternatively, could such estimates be reasonably made at the level of the market (e.g., identifying an index of industry sector spreads and stratifying spreads into certain ranges) and mapped to loss rates set by FCA?

9. How might a set of loss rates be developed for each spread stratum?

10. Are there any existing objective tools or approaches that could readily replace references to ratings issued by NRSROs in the RBCST?

11. What other approaches or methodologies not discussed above should FCA consider?

12. What methodologies or approaches should FCA consider to more explicitly incorporate a derivatives counterparty exposure charge into the RBCST?

13. What is the best manner of evaluating minimum capital requirements on derivative counterparty exposures in the RBCST and should a pre-processing model be constructed (i.e., a sub-model used to derive inputs into the RBCST) to represent this risk--both in terms of missed individual contractual cash flows as well the replacement cost on defaulted derivatives? If so, how should replacement costs be estimated?

14. Should Farmer Mac be required to include strategies in its marketing plans that address how its secondary market programs and products will be offered to all qualified borrowers, including:

(a) Minorities, the disabled, and women;
(b) Young, beginning, small, and family farms and cooperatives; or
(c) Non-traditional agricultural producers, such as local food systems, organic or specialty crop farmers and the lenders who serve them? Why or why not?

15. Should Farmer Mac's marketing plans set quantitative goals to increase purchases of, or commitments to purchase, loans to young, beginning, small, and family farms, and those owned or operated by minorities, the disabled, and women? If so, what would be the best method to apply such goals to rural utility cooperatives (e.g., minority-managed cooperatives or cooperatives that serve predominantly minority residential customers or minority-owned commercial customers)?

16. To what extent should FCA regulations require Farmer Mac to develop a human capital plan as part of its strategic and operational business plan to foster diversity in its workforce and succession planning?

Dated: June 10, 2011

Mary Alice Donner,
Acting Secretary,
Farm Credit Administration Board.

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[1] Pub. L. 92-181, 85 Stat. 583, 12 U.S.C. 2001 et seq. (December 10, 1971).
[2] Pub. L. 111-203, 124 Stat. 1376, (H.R. 4173), July 21, 2010.
[3] 12 U.S.C. 2279bb-1.
[4] Section 5406 of Pub. L. 110-246, 122 Stat. 1651 (June 18, 2008)(repealing and replacing Pub. L. 110-234).
[5] Emery K., Ou S., Tennant, J., Kim F., Cantor R., "Corporate Default and Recovery Rates, 1920 – 2009," published by Moody's Investors Service, February 2010.
[6] See 75 FR 49423 (Aug. 13, 2010), 75 FR 52283 (Aug. 25, 2010), and 76 FR 5292 (Jan. 31, 2011).

78 FR 5320, 01/25/2013

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[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 652

RIN 3052-AC80

Federal Agricultural Mortgage Corporation Funding and Fiscal Affairs; Farmer Mac Capital Planning

AGENCY: Farm Credit Administration (FCA or Agency).

ACTION: Proposed rule.

SUMMARY: The FCA, through the Office of Secondary Market Oversight (OSMO), is proposing regulations to require the Federal Agricultural Mortgage Corporation (Farmer Mac) to submit a capital plan to OSMO on an annual basis and to require Farmer Mac to notify OSMO under certain circumstances before making a capital distribution. The proposed rule would revise the current capital adequacy planning requirements to increase our regulatory focus on the quality and level of Farmer Mac's capital base and promote best practices for capital adequacy planning and stress testing. We view high quality capital as the fundamental resource available to cover unexpected losses and ensure long-term financial flexibility and viability.

DATES: Please submit comments before March 26, 2013.

ADDRESSES: Commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (faxes) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we no longer accept comments submitted by fax. Regardless of the method you use, please do not submit your comments multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send an e-mail to reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Laurie A. Rea, Director, Office of Secondary Market Oversight, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia or on our Web site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit

items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Joseph T. Connor, Associate Director for Policy and Analysis, Office of Secondary Market Oversight, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4280, TTY (703) 883-4434;

or

Rebecca S. Orlich, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objective

The objective of this proposed rule is to improve the long-term safety and soundness and continuity of Farmer Mac operations so that Farmer Mac may better fulfill its public mission under a range of economic conditions. To achieve this, FCA is proposing to revise operational and strategic business planning requirements to enhance capital adequacy planning. The proposed rule is designed to (i) establish minimum supervisory standards for the capital planning process, including stress testing, (ii) describe how the Farmer Mac board of directors (board) and senior management should implement the process and strategies, and (iii) provide FCA with notification of Farmer Mac's proposed capital distributions before they occur.

II. Background

Farmer Mac is an institution of the Farm Credit System, regulated by FCA through its Office of Secondary Market Oversight. Farmer Mac was established and chartered by Congress to create a secondary market for agricultural real estate mortgage loans, rural housing mortgage loans, and rural utilities loans, and it is a stockholder-owned instrumentality of the United States. Title VIII of the Farm Credit Act of 1971, as amended (Act), governs Farmer Mac.[1]

Farmer Mac Programs

Under the Farmer Mac I program, Farmer Mac guarantees prompt payment of principal and interest on securities representing interests in, or obligations backed by, mortgage loans secured by first liens on agricultural real estate or rural housing. It also purchases, or commits to purchase, qualified loans or securities backed by qualified loans directly from lenders. Under the Farmer Mac II program, Farmer Mac purchases and securitizes portions of certain loans guaranteed by the U.S. Department of Agriculture, including farm ownership and operating loans and rural business and community development loans. Farmer Mac also guarantees the timely payment of principal and interest on the securities created from these loans. In 2008, Congress authorized Farmer Mac to purchase and guarantee securities backed by loans to rural electric and telephone utility cooperatives.

III. Need for Enhanced Capital Planning

The fundamental purpose of bank capital is to provide a cushion to absorb unexpected losses and

improve an institution's long-term resilience. The recent global financial crisis underscored the importance of capital adequacy planning, including maintaining high quality capital. In response to the crisis, the Basel Committee on Banking Supervision (BCBS) proposed the Basel III framework, which expands and clarifies international standards on regulatory capital with the intent to raise the quality, quantity, and transparency of regulatory capital.[2] The Basel III framework also requires banks to run stress tests to ensure they are able to sustain financial soundness under adverse market conditions. In the U.S., the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was enacted in July 2010 to strengthen regulation of the financial sector. Section 165 of the Dodd-Frank Act requires certain financial companies whose total consolidated assets are in excess of $10 billion to conduct annual stress tests. The U.S. banking agencies (the Federal Reserve System (FRS), Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC)) and the Federal Housing Finance Agency (FHFA) have issued proposed, and in some cases, final rules and guidance to enhance capital standards and stress testing.[3] This proposed rule reflects our general agreement with the rulemaking actions of other banking supervision authorities, both domestic and international, which emphasize high quality capital maintenance, robust planning, and stress testing as adding value to the existing regulatory framework for capital adequacy and capital planning.

Farmer Mac's statutory capital standards were enacted in 1991[4] and have not been updated since 1996.[5] Under the Act, Farmer Mac must operate at or above a minimum "core capital" level and a minimum "regulatory capital" level. "Core capital" is defined in section 8.31(2) of the Act as the par value of outstanding common and preferred stock, paid-in capital, and retained earnings. Farmer Mac's minimum core capital requirement is an amount equal to the sum of 2.75 percent of on-balance-sheet assets and 0.75 percent of off-balance-sheet obligations. "Regulatory capital" is defined in section 8.31(5) as core capital plus an allowance for losses and guarantee claims (ALL). Farmer Mac's minimum risk-based capital requirement is the amount of regulatory capital for interest rate and credit risk determined by applying a risk-based capital stress test (RBCST) as defined in section 8.32(a) of the Act, plus an additional 30 percent of that amount for management and operations risk.

The regulatory requirements of the RBCST were implemented in FCA's regulations at 12 CFR part 652, subpart B in 2002 and have been revised several times. While the RBCST provides a valuable alternative perspective as a risk index of Farmer Mac's operations from quarter to quarter, the Act prescribes several components of the model's design that constrain its usefulness as the only approach to calculating risk-based capital required by regulation. Under certain conditions, the Act's provisions do not impose a significant level of stress; for example, the Act's interest rate stress provisions do not impose a stressful scenario of interest rate shock in very low interest rate environments such as the current one.[6] Moreover, there are a number of areas of the statutory design requirements in the RBCST that may no longer reflect best practices in economic capital modeling, which has advanced considerably since the provisions were enacted. We believe applying current best practices for comprehensive and robust stress testing approaches is prudent and warranted for capital planning.

In addition, the Act's minimum regulatory capital standards do not necessarily ensure that Farmer Mac holds a sufficient amount of high quality capital—primarily common equity and retained earnings—to survive periods of high financial stress. The statutory definition of "core capital" broadly defines the types of capital instruments that may be included without distinguishing the quality of the capital instruments. More recent views of capital, including the Basel III framework for stock corporations, make much finer distinctions between, for example, different structures of preferred stock on the basis of the terms of their underlying contractual provisions. These finer distinctions include how much incentive is built into preferred stock terms for the issuer to redeem the shares. An example of such an incentive would be significant step-ups in dividend rates over time. Such provisions create greater uncertainty around the relative permanence of that capital and, therefore, how available it will be to cover unexpected

losses in the future.

Consistent with the view that high quality capital is the fundamental resource available to cover unexpected losses and ensure long-term financial flexibility and viability, we propose to revise the current capital adequacy planning requirements to increase our regulatory focus on the quality and level of capital and advance best practices for capital adequacy planning and stress testing at Farmer Mac.

IV. **Proposed Revisions**

We propose to revise our regulation on Corporation Board Guidelines by deleting the provisions related to the capital adequacy plan that is part of the operational and strategic business plan requirement in existing § 652.60(b)(5) and (c) and creating a new § 652.61 with revised and expanded guidance on capital planning. In § 652.60(a), we propose to add the requirement that Farmer Mac's capital be sufficient to meet goals and objectives in a newly proposed element (in § 652.61(c)) of its operational and strategic business plan. We further propose to require Farmer Mac to notify the OSMO within 10 calendar days of determining that capital is not sufficient to meet this new requirement. In § 652.60(b), we propose to add several items that Farmer Mac must address in its business plan. These include a business and organizational overview and an assessment of management capabilities; an assessment of Farmer Mac's strengths and weaknesses; strategies for achieving mission, financial, and business goals and objectives; and a marketing plan. We propose to add to the required review of internal and external factors likely to affect Farmer Mac during the business planning period a required discussion of how factors might impact Farmer Mac's current financial position and business goals.

In new § 652.61, we propose to require Farmer Mac to develop and maintain an annual capital plan and to submit the plan for FCA review. The revisions generally refer to a required capital plan rather than the existing rule's references to capital adequacy planning, and the proposed requirements, while more specific and detailed, are very similar in their overall objective. As described more fully below, Farmer Mac would be required to calculate a high quality capital ratio as well as the ratios described in the Act and existing regulations. In proposed § 652.62, we would require Farmer Mac to notify the FCA prior to making a capital distribution under certain circumstances.

A. **Annual Capital Planning Requirement**

We propose to define a capital plan as a written presentation of Farmer Mac's capital planning strategies and capital adequacy process that includes certain mandatory elements. The proposed capital plan would be organized into four main components, each with specified mandatory elements. The four mandatory elements are:

(1) An assessment of the expected uses and sources of capital over the planning horizon (at least 12 quarters, beginning with the quarter preceding the quarter in which Farmer Mac submits its capital plan) that reflects Farmer Mac's size, complexity, risk profile and scope of operations, assuming both expected and stressful conditions;

(2) A detailed description of Farmer Mac's process for assessing capital adequacy;

(3) Farmer Mac's capital policy; and

(4) A discussion of any expected changes to Farmer Mac's business plan that are likely to have a material impact on its capital adequacy or liquidity.

The first mandatory element, the assessment of uses and sources of capital, must contain the following components: (i) Estimates of projected revenues, losses, reserves, and pro forma capital levels, including any minimum statutory or regulatory capital ratio, a high-quality Tier 1 ratio as described below, and any additional capital measures deemed relevant by Farmer Mac, over the planning horizon under expected conditions and under a range of stressed scenarios, including any scenarios provided by FCA and at least two stressed scenarios developed by Farmer Mac appropriate to its business model and portfolios; such scenarios could include agricultural and general economic conditions that cause increases in delinquency rates caused by any variety of factors (e.g., widespread, weather-related crop losses), interest rate spikes that could impact historically high cropland values and the cost of debt funding, changes in laws that affect plant-based renewable fuels subsidies, as well as liquidity-related stress such as reduced access to debt markets; and (ii) a description of all planned capital actions over the planning horizon. We propose to define a capital action as any issuance of a debt or equity capital instrument, a capital distribution, or any similar action that the FCA determines could impact Farmer Mac's capital. A capital distribution would include a redemption or repurchase of any debt or equity capital instrument, a dividend payment, a payment that may be temporarily or permanently suspended by Farmer Mac on any instrument that is eligible for inclusion in total equity (as reported in accordance with GAAP), and any similar transaction that the Agency determines to be in substance a distribution of capital.

The second mandatory element of the capital plan, the process for assessing capital adequacy, must contain the following components: (i) A discussion of how Farmer Mac will, under normal and stressful conditions, be able to maintain capital commensurate with its risks, maintain capital above the minimum statutory and regulatory capital ratios and above a Tier 1 ratio set in accordance with the board's clearly articulated risk tolerance policy; and (ii) a discussion of how Farmer Mac will, under both normal and stressful conditions, maintain sufficient capital to continue its operations by maintaining ready access to funding, meeting its obligations to creditors and other counterparties, and continuing to serve as secondary market for qualifying rural markets; and (iii) a discussion of the results of any stress test required by law or regulation, including the RBCST, and an explanation of how the capital plan takes these results into account.

We do not propose to establish a new regulatory minimum capital requirement in this rule. Rather, we propose to require Farmer Mac to establish an internal minimum standard in accordance with widely recognized approaches as a part of board policy on capital. To comply with the proposed requirements of the Tier 1 ratio, Farmer Mac must utilize an approach that is in accordance with an appropriate Basel framework (or frameworks), or comparable U.S. regulatory frameworks in effect (e.g., Standardized or advanced internal ratings based (Advanced) approaches, or both).[7] The approach selected to calculate risk-weighted assets must be appropriate given Farmer Mac's business activities and must be consistent with broadly accepted banking practices and standards (e.g., Basel accords or similar U.S. regulations, including those applied by Farm Credit System banks and associations under part 615 of the FCA's regulations). The OSMO strongly recommends that, for capital planning purposes, Farmer Mac calculate and report in its business plan the ratio of Tier 1 capital to risk-weighted assets using both the Basel Standardized approach and the Advanced approach to provide alternative perspectives on the Farmer Mac's risk-bearing capacity.

The third mandatory element of the capital plan, the capital policy, is a written assessment of the principles and guidelines used for capital planning, capital issuance, usage and distributions, including internal capital goals, the quantitative or qualitative guidelines for dividend and stock repurchases, the strategies for addressing potential capital shortfalls, and the internal governance procedures around capital policy principles and guidelines.

Finally, the fourth mandatory element of Farmer Mac's capital plan is a discussion of any

expected changes to Farmer Mac's business plan that are likely to have a material impact on capital adequacy or liquidity. For example, the capital plan should reflect any expected material effects of new lines of business or activities on Farmer Mac's capital adequacy or liquidity, including revenue and losses.

We propose to require the board, at least annually, to review the robustness of the process for assessing capital adequacy, ensure that any deficiencies in the process for assessing capital adequacy are appropriately remedied, and approve the capital plan. The robustness of Farmer Mac's capital adequacy process should be evaluated based on the following elements:

(i) A sound risk management infrastructure that supports the identification, measurement, and assessment of all material risks arising from the business activities of Farmer Mac;

(ii) An effective process for translating risk measures into estimates of potential loss over a range of adverse scenarios and for aggregating those estimated losses across Farmer Mac;

(iii) A clear definition of available capital resources and an effective process for forecasting available capital resources over the same range of adverse scenarios used for loss forecasting;

(iv) A process for considering the impact of loss estimates on capital adequacy consistent with Farmer Mac's stated goals for the level and composition of capital and for taking into account any limitations of the company's capital adequacy process and its components;

(v) A process, supported by Farmer Mac's capital policy, to use its assessments of the impact of loss and resource estimates on capital adequacy to make key decisions regarding the current level and composition of capital, specific capital actions, and capital contingency plans as they affect capital adequacy;

(vi) Sound internal controls governing the capital adequacy process, including sufficient documentation, model validation and independent review, and audit testing; and
(vii) Effective board and senior management oversight of Farmer Mac's capital adequacy process, including periodic review of capital goals, assessment of the appropriateness of adverse scenarios considered in capital planning, regular review of any limitations and uncertainties in the process, and approval of planned capital actions.

B. FCA's Review of Capital Plans

FCA expects to consider the following factors in reviewing Farmer Mac's capital plan: (1) The comprehensiveness of the capital plan, including the extent to which the analysis underlying the capital plan captures and addresses potential risks stemming from activities across Farmer Mac's operations and its capital policy; (2) the reasonableness of its assumptions and analysis underlying the capital plan and its methodologies for reviewing the robustness of its capital adequacy process; and (3) its ability to maintain capital above the board-established minimum Tier 1 Capital to risk-weighted assets ratio on a pro forma basis under both normal and stressful conditions throughout the planning horizon, including but not limited to any stressed scenarios required under this rule.

The FCA would also consider the following information in reviewing Farmer Mac's capital plan:

(i) Relevant supervisory information about Farmer Mac and its subsidiaries;

(ii) Farmer Mac's regulatory and financial reports, as well as supporting data that will allow for an analysis of the loss, revenue, and reserve projections;

(iii) Compliance with statutory and regulatory minimum capital standards;

(iv) As applicable, the FCA's own pro forma estimates of Farmer Mac's potential losses, revenues, reserves, and resulting capital adequacy under both normal and stressful conditions, including but not limited to any stressed scenarios required under the final rule, as well as the results of any stress tests conducted by Farmer Mac or the FCA; and

(v) Other information requested or required by the FCA, as well as any other information relevant to Farmer Mac's capital adequacy.

C. FCA Action on a Capital Plan

OSMO would review the capital plan and provide an assessment to Farmer Mac of the capital adequacy and planning process through its normal examination and oversight program. In determining whether a capital plan or proposed capital distributions would constitute an unsafe or unsound practice, the FCA will consider whether Farmer Mac is and will remain in sound financial condition after giving effect to the capital plan and proposed capital distributions.

OSMO may require Farmer Mac to submit additional data about planning assumptions, stress test strategies, and other qualitative and quantitative information. OSMO may also require Farmer Mac to revise and re-submit its capital plan.

D. Farmer Mac's Response to OSMO's Review

We propose to require Farmer Mac to take into account the results of the stress tests conducted under the requirements of this section, as well as OSMO's assessment, in making changes as appropriate to Farmer Mac's capital structure (including the level and composition of capital); its exposures, concentrations, and risk positions; any plans for recovery and resolution; and overall risk management. In addition, Farmer Mac must document in writing any changes it makes to its capital structure such as issuance or retirement of equity securities, as well as decisions not to make such changes with respect to any shortcomings noted in OSMO's assessment.

V. Prior Notice Requirements

A. Notice to OSMO of Capital Distributions

We believe an enhanced level of dialogue between the Agency and Farmer Mac in advance of capital distributions will improve the level of FCA's oversight of, and communication with, regulated entity. Such enhanced dialogue would provide the board with valuable external perspective on such decisions from both a safety and soundness and mission achievement points of view. In new § 652.62, we propose to require Farmer Mac to provide OSMO with notice 15 calendar days prior to a board action to declare a capital distribution. We expect such notice to include a description of the capital distribution including, for redemptions or repurchases of securities, the gross consideration to be paid and the terms and sources of funding for the transaction, and for dividends, the amount of the dividend, as well as any additional information requested by OSMO (which could include, among other things, an assessment of Farmer Mac's capital adequacy under a stress scenario specified by OSMO.) There would be an exception to the notice requirement for dividends on common and preferred stock when there is no

change from the amount of the dividends paid in the previous period.

VI. Regulatory Flexibility Act

Farmer Mac has assets and annual income in excess of the amounts that would qualify it as a small entity. Therefore, Farmer Mac is not a "small entity" as defined in the Regulatory Flexibility Act. Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FCA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities.

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[1] The Act is set forth at 12 U.S.C. 2001 et seq. Title VIII is in 12 U.S.C. 2279aa-2279cc.

[2] Bank for International Settlements, Basel Committee on Banking Supervision, Basel III, A Global Regulatory Framework for More Resilient Banks and Banking Systems, December 2010 (revised June 2011), http://www.bis.org/publ/bcbs189.pdf. The United States is a member of the BCBS.

[3] See, e.g., the FRS's final rule, Capital Plans, 76 FR 74631 (December 1, 2011); the FRS's proposed rule, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 FR 594 (January 5, 2012); the U.S. banking agencies' joint proposed rule, Regulatory Capital Rules; Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule, 77 FR 52978 (August 30, 2012); the FDIC's proposed rule, Annual Stress Test, 77 FR 3166 (December 23, 2012); the OCC's proposed rule, Annual Stress Test, 77 FR 3408 (January 24, 2012); and the FHFA's proposed rule, Stress Testing of Regulated Entities, 77 FR 60948 (October 5, 2012).

[4] Pub. L. 102-237, Title V, December 13, 1991.

[5] Pub. L. 104-105, Title I, February 10, 1996.

[6] Section 8.32(a)(2) requires interest rate shocks to be specified as the lesser of: a) 50 percent of the 12-month average rates on 10-year Treasury obligations; or b) 600 basis points. In the current interest rate environment, this requirement translates into an interest rate shock of just slightly more than 100 basis points.

[7] Publications by the BCBS explaining these approaches include: (1) International Convergence of Capital Measurement and Capital Standards, A Revised Framework Comprehensive Version, June 2006; (2) Enhancements to the Basel II framework July 2009; and (3) Basel III, A Global Regulatory Framework for More Resilient Banks and Banking Systems, December 2010 (revised June 2011).

List of Subjects in 12 CFR Part 652

Agriculture, Banks, banking, Capital, Investments, Rural areas.

For the reasons stated in the preamble, part 652 of chapter VI, title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 652--FEDERAL AGRICULTURAL MORTGAGE CORPORATION FUNDING AND FISCAL AFFAIRS

1. The authority citation for part 652 continues to read as follows:

Authority: Secs. 4.12, 5.9, 5.17, 8.11, 8.31, 8.32, 8.33, 8.34, 8.35, 8.36, 8.37, 8.41 of the Farm Credit Act (12 U.S.C. 2183, 2243, 2252, 2279aa-11, 2279bb, 2279bb-1, 2279bb-2, 2279bb-3, 2279bb-4, 2279bb-5, 2279bb-6, 2279cc); sec. 514 of Pub. L. 102-552, 106 Stat. 4102; sec. 118 of Pub. L. 104-105, 110 Stat. 168.

2. Revise § 652.60 to read as follows:

§ 652.60 Corporate business planning.

(a) Your board of directors is responsible for ensuring that you maintain capital at a level that is sufficient to ensure continued financial viability and provide for growth. In addition, your capital must be sufficient to meet statutory and regulatory requirements as well as the goals and objectives in the required element of your capital plan in § 652.61(c)(2)(i)(B). You must notify the OSMO within 10 calendar days of determining that capital is not sufficient to meet those goals and objectives.

(b) No later than 65 days after the end of each calendar year, your board of directors must adopt an operational and strategic business plan for at least the next 3 years. The plan must include:

(1) A mission statement;

(2) A business and organizational overview and an assessment of management capabilities;

(3) An assessment of Farmer Mac's strengths and weaknesses;

(4) A review of the internal and external factors that are likely to affect you during the planning period;

(5) Measurable goals and objectives;

(6) A discussion of how these factors might impact Farmer Mac's current financial position and business goals;

(7) Forecasted income, expense, and balance sheet statements for each year of the plan;

(8) A marketing plan, and

(9) A capital plan in accordance with § 652.61.

3. Add new §§ 652.61 and 652.62 to read as follows:

§ 652.61 Capital planning.

(a) *Purpose*. This section establishes capital planning requirements for Farmer Mac.

(b) *Definitions*. For purposes of this section and § 652.62, the following definitions apply:

Basel III means the Basel Committee on Banking Supervision's document "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems," June 2011 and as it may be updated from time to time.

Capital action means any issuance of a debt or equity capital instrument, and any capital distribution, as well as any similar action that OSMO determines could impact Farmer Mac's consolidated capital.

Capital distribution means a redemption or repurchase of any debt or equity capital instrument, a payment of common or preferred stock dividends, a payment that may be temporarily or permanently suspended by the issuer on any instrument that is eligible for inclusion in the numerator of any minimum capital ratio, and any similar transaction that OSMO determines to be in substance a distribution of capital.

Capital plan means a written presentation of Farmer Mac's capital planning strategies and capital adequacy process that includes the mandatory elements set forth in paragraph (c)(2) of this section.

Capital policy means Farmer Mac's written assessment of the principles and guidelines used for capital planning, capital issuance, usage and distributions, including internal capital goals; the quantitative or qualitative guidelines for dividend and stock repurchases; the strategies for addressing potential capital shortfalls; and the internal governance procedures around capital policy principles and guidelines.

Planning horizon means the period of at least 12 quarters, beginning with the quarter preceding the quarter in which Farmer Mac submits its capital plan, over which the relevant projections extend.

Tier 1 Capital means the components meeting the criteria of Common Equity Tier 1 Capital and Additional Tier 1 Capital and the regulatory adjustments as set forth in Basel III, or Tier 1 Capital as defined in regulations of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, or the Federal Deposit Insurance Corporation, as revised from time to time; or another capital standard to measure high quality capital as approved for use under this regulation by the Director of OSMO.

Tier 1 ratio means the ratio of Farmer Mac's Tier 1 Capital to Total Risk-Weighted Assets.

Total Risk-Weighted Assets means a risk-weighting approach that is appropriate given Farmer Mac's business activities and consistent with broadly accepted banking practices and standards (e.g., one of the frameworks of the Basel Committee on Banking Supervision or similar U.S. regulations).

(c) *General requirements*.

(1) *Annual capital planning*.

(i) Farmer Mac must develop and maintain a capital plan each year.

(ii) Farmer Mac must submit its complete annual capital plan to OSMO by March 1 or such later date as directed by OSMO, after consultation with the FCA Board.

(iii) Prior to submission of the capital plan under paragraph (c)(1)(ii) of this section, Farmer Mac's board of directors must:

(A) Review the robustness of Farmer Mac's process for assessing capital adequacy,

(B) Ensure that any deficiencies in Farmer Mac's process for assessing capital adequacy are appropriately remedied; and

(C) Approve Farmer Mac's capital plan.

(2) *Mandatory elements of capital plan*. The capital plan must contain at least the following elements:

(i) An assessment of the expected uses and sources of capital over the planning horizon that reflects Farmer Mac's size, complexity, risk profile, and scope of operations, assuming both expected and stressful conditions, including:

(A) Projected revenues, losses, reserves, and pro forma capital levels, including the core capital and regulatory capital ratios required by sections 8.32 and 8.33 of the Act, the Tier 1 ratio as defined in this section, and any additional capital measures deemed relevant by Farmer Mac, over the planning horizon under expected conditions and under a range of at least two progressively severe stress scenarios developed by Farmer Mac appropriate to its business model and portfolios, as well as any scenarios provided by the Director of OSMO. At least 15 calendar days prior to this stress testing, Farmer Mac must provide to OSMO a description of the expected and stressed scenarios that Farmer Mac intends to use to conduct its annual stress test under this section.

(B) A description of all planned capital actions over the planning horizon.

(ii) A detailed description of Farmer Mac's process for assessing capital adequacy, including:

(A) A discussion of how Farmer Mac will, under expected and stressed conditions, maintain

capital commensurate with its risks, maintain capital above the minimum core capital and regulatory capital ratios and above the Tier 1 ratio set in accordance with a well-articulated risk tolerance policy established by the board of directors;

(B) A discussion of how Farmer Mac will, under expected and stressed conditions, maintain sufficient capital to continue its operations by maintaining ready access to funding, meeting its obligations to creditors and other counterparties, and continuing to serve its statutory purposes; and

(C) A discussion of the results of the risk-based stress test required by section 8.32 of the Act and the stress tests required by this section, as well as any other stress test required by law or regulation, and an explanation of how the capital plan takes these results into account.

(iii) Farmer Mac's capital policy; and

(iv) A discussion of any expected changes to Farmer Mac's business plan that are likely to have a material impact on the Corporation's capital adequacy or liquidity.

(d) Review of capital plan by OSMO.

(1) OSMO will consider the following factors in reviewing Farmer Mac's capital plan:

(i) The comprehensiveness of the capital plan, including the extent to which the analysis underlying the capital plan captures and addresses risks stemming from activities across Farmer Mac's operations;

(ii) The reasonableness of Farmer Mac's assumptions and analysis underlying the capital plan and its methodologies for reviewing the robustness of its capital adequacy process; and

(iii) Farmer Mac's ability to maintain capital above the minimum core capital and regulatory capital ratios and above a Tier 1 ratio set in accordance with a well-articulated risk tolerance policy established by the board of directors on a pro forma basis under expected and stressful conditions throughout the planning horizon, including but not limited to any stressed scenarios required under paragraph (c)(2)(i)(A) and (c)(2)(ii) of this section.

(iv) All supervisory information about Farmer Mac and its subsidiaries;

(v) Farmer Mac's regulatory and financial reports, as well as supporting data that would allow for an analysis of its loss, revenue, and projections;

(vi) As applicable, OSMO's own pro forma estimates of Farmer Mac's potential losses, revenues, and resulting capital adequacy measurements under expected and stressful conditions, including but not limited to any stressed scenarios required under paragraphs (c)(2)(i)(A) and (c)(2)(ii) of this section, as well as the results of any other stress tests conducted by Farmer Mac or OSMO; and

(vii) Other information requested or required by OSMO, as well as any other information relevant to Farmer Mac's capital adequacy.

(e) OSMO action on a capital plan.

(1) OSMO will review the capital plan and provide an assessment to Farmer Mac of the capital adequacy and planning process through its ongoing examination and oversight process.

(2) Upon a request by OSMO, Farmer Mac must provide OSMO with sufficient information regarding its planning assumptions, stress test strategies and results and any other relevant qualitative or quantitative information requested by OSMO to facilitate review of Farmer Mac's capital plan under this section.

(3) OSMO may require Farmer Mac to revise and re-submit its capital plan.

(f) Farmer Mac response to OSMO's assessment. Regardless of whether re-submission is required, Farmer Mac must take the results of the stress tests conducted under paragraph (c)(2)(i)(A) and (c)(2)(ii) of this section (including any revisions required under paragraph (e)(3) of this section) as well as OSMO's assessment into account in making changes, as appropriate, to Farmer Mac's capital structure (including the level and composition of capital); its exposures, concentrations, and risk positions; any plans for recovery and resolution; and to improve overall risk management. Farmer Mac must document in writing its actions in response to the stress tests and assessment, as well as decisions not to take actions in response to any issues raised in the assessment.

§ 652.62 Notice to OSMO of capital distributions.

(a) Farmer Mac must provide OSMO with notice 15 calendar days prior to a board consideration of a declaration of a capital distribution or any material changes in capital distributions policies.

(b) Notice under paragraph (a) of this section is not required with respect to a regular periodic payment of dividends on common stock and preferred stock when there is no change in the amount of payment per share from the previous period.

Dated: January 18, 2013

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.

77 FR 56571, 09/13/2012

Handbook Mailing HM-12-5

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Parts 604, 611, 612, 619, 620, 621, 622, 623, and 630

RIN 3052-AC65

Unincorporated Business Entities

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, we, or our) is proposing to establish a regulatory framework for Farm Credit System (System) institutions' use of unincorporated business entities (UBEs) organized under State law for certain business activities. For purposes of this proposed rule, a UBE includes limited partnerships (LPs), limited liability partnerships (LLPs), limited liability limited partnerships (LLLPs), limited liability companies (LLCs), and any other unincorporated business entities, such as unincorporated business trusts, organized under State law. This rule does not apply to UBEs that one or more System institutions may establish as Rural Business Investment Companies (RBICs) pursuant to the institutions' authority under the provisions of title VI of the Farm Security and Rural Investment Act of 2002, as amended (FSRIA), and United States Department of Agriculture (USDA) regulations implementing FSRIA. This rule does apply, however, to System institutions that organize UBEs for the express purpose of investing in RBICs.

DATES: Comments on this proposed rule must be submitted on or before November 13, 2012.

ADDRESSES: We offer a variety of methods for you to submit your comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the FCA's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we do not accept comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: http://www.fca.gov. Select "Public Commenters," then "Public Comments," and follow the directions for "Submitting a Comment."
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- Mail: Barry F. Mardock, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of all comments we receive at our office in McLean, Virginia, or from our Web

site at http://www.fca.gov. Once you are in the Web site, select "Public Commenters," then "Public Comments," and follow the directions for "Reading Submitted Public Comments." We will show your comments as submitted, but for technical reasons we may omit items such as logos and special characters. Identifying information you provide, such as phone numbers and addresses, will be publicly available. However, we will attempt to remove e-mail addresses to help reduce Internet spam.

FOR FURTHER INFORMATION CONTACT:

Elna Luopa, Senior Corporate Analyst, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4414, TTY (703) 883-4434,

or

Wendy Laguarda, Assistant General Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of this proposed rule are to:

- Affirm FCA's authority to regulate and examine the System institutions' use of UBEs, including the authority to impose any conditions FCA deemed necessary and appropriate on UBE business activity, and to take enforcement action against System institutions' activities involving UBEs;
- Prohibit System institutions from using UBEs to engage in direct lending or any activity that exceeds their authority under the Act or circumvents the application of cooperative principles;
- Limit the amount of a System institution's equity investments in UBEs;
- Create a process for FCA review and approval of requests by System institutions to organize or invest in UBEs for certain business activity;
- Establish standards for the proper and adequate disclosure and reporting of System UBE activity; and
- Ensure that the System's use of UBEs remains transparent and free from conflicts of interest.

II. Background

Beginning in the early 1980s, FCA approved joint ventures among System institutions, as well as System institution contractual alliances with non-System entities, that sought to improve the reliability and delivery of authorized products and services to agriculture and rural America. These collaborative initiatives enabled System institutions to provide services and products more efficiently and inexpensively, resulting in improved and less costly services and products to the farmer and rancher System borrowers and rural communities.

Business models and structures have significantly evolved since the 1980s, as more and more States have adopted uniform statutes governing unincorporated, largely limited liability, business structures. The System's use of UBEs has been a logical outgrowth of its earlier collaborative initiatives implemented through joint ventures and alliances. Like these earlier joint initiatives, UBEs enable the System to provide more efficient, less costly services and products to the agricultural or rural community,

but through more sophisticated, formal and flexible structures that address ownership rights, management, operations, assumptions of liability, allocation of profits and losses and payment of taxes. Further, UBEs have the added advantage of providing more protection for System stockholders by enabling a System institution to limit its liability to the amount of its equity investment in a UBE.

III. The Statutory Basis for the Proposed Rule

A. System Institutions' Authority

The System's existing investment[1] and incidental powers[2] provide the authorities for System institutions to invest in and form UBEs for certain business activity. Specifically, under § 615.5140(e), System institutions may exercise their investment authorities to invest in "other investments approved by the FCA" provided the funding bank has approved the investment. System investments in UBEs fall under this category, and may be approved by FCA upon a request that explains the risk characteristics of the investment and the System institution's purpose and objectives for making the investment.

Unlike the express authority to organize service corporations under sections 4.25 and 4.28(A) of the Act,[3] no provision under the Act explicitly authorizes System institutions to organize entities under State law to engage in business activity. However, Congress has long encouraged coordinated initiatives by System institutions to provide joint products, services or functions to System borrowers. We note that the farmer-owned, cooperative and jointly liable System, by its very establishment, is designed to accomplish the most efficient and effective delivery system of credit and related services to agriculture and its producers and rural communities. Moreover, various provisions in the Act have authorized or directed System institutions to offer joint products or services. The same year that Congress added the service corporation authority to the Act (1980), it also directed System institutions to establish programs for young, beginning and small (YBS) farmers and ranchers "in coordination with other units of the Farm Credit System serving the territory and with other governmental and private sources of credit."[4] These 1980 additional authorities evidence Congress' intention that System institutions be able to provide coordinated services and products to System borrowers and rural communities using business structures that can best facilitate such efforts.

In fact, System institutions, with FCA approval, have been using their incidental authority to enter into non-corporate joint ventures to promote coordinated and expedient initiatives, which in recent years have included State-chartered UBEs.

This proposed rule will provide a more uniform approval and oversight process for the System's continuing use of UBEs. The rule emphasizes that incidental powers can neither be the basis for broadening or circumventing the limitations and restrictions of a System institution's express powers in carrying on the business of the bank or association nor used to engage in activities that are impermissible under the Act. The delivery of System credit, services and other products will still chiefly be provided by System institutions' direct use of their express powers to serve their eligible borrowers and customers. As a Government-sponsored enterprise (GSE) of cooperative institutions owned and controlled by their member-borrowers, it is essential that System institutions maintain their strong cooperative traditions and reputations.[5]

In recognizing changing business practices through the System's use of UBEs, the preservation of the System's member-focused principles remains paramount. This proposed rule would therefore prohibit System institutions from engaging in direct lending activities or any other activity through UBEs that circumvents the application of cooperative principles such as borrower rights, stock ownership, voting rights or patronage.

Finally, to provide transparency to the public, FCA intends to post on its Web site the name and business purpose of UBEs organized and controlled by one or more System institutions that are approved under this rule.

B. FCA Authority over System Investments in UBEs and UBE Business Activity

Under part C of title V of the Act, FCA has the ability to take an enforcement action against a System institution in connection with its equity investment in and use of a UBE for business activity to ensure an institution's safety and soundness.

IV. Section-by-Section Analysis

A. Unincorporated Business Entities [new §§ 611.1150 through 611.1158]

We propose adding a new subpart J to part 611 that would address the purpose and scope of unincorporated business entities organized or invested in by System institutions. Subpart J includes provisions on: (1) Definitions; (2) FCA's regulatory, examination, enforcement, and assessment authorities; (3) general restrictions and prohibitions on the use of UBEs; (4) notice-only requirements for certain activities conducted through UBEs; (5) FCA's review process for UBEs not meeting the notice-only provisions; (6) ongoing requirements; (7) disclosure and reporting requirements; and (8) transparency and conflict of interest requirements. Subpart J also contains a grandfather provision for those UBEs previously approved by FCA on a case-by-case basis and for those UBEs established under the guidance provided in FCA Bookletter BL-057,[6] which may be rescinded once a final rule becomes effective.

1. Purpose and Scope [new § 611.1150]

Proposed § 611.1150 affirms that System institutions have incidental power as may be necessary or expedient to carry on the business of the bank or association, as applicable. In exercising this incidental power, System institutions may continue to establish UBEs, provided the UBE business activity is necessary or expedient to the System institution's express authorities in carrying on the business of the bank or association and falls within the parameters of the rule.

The proposed rule would apply to any System institution that organizes or invests in a UBE for the delivery of services or functions. This proposed rule also pertains to any System institution that has an equity investment in a System-organized and controlled UBE regardless of the amount of the investment. The proposed rule would also apply to any System institution that is a partner or member of a UBE organized to acquire and manage unusual or complex collateral associated with loans under FCA Bookletter BL-057.

Except as authorized by this rule, System institutions cannot manage, control, or invest in any State-chartered or organized business entity. The proposed rule would not permit System institutions to make equity investments in UBEs that are organized, controlled or managed by a non-System entity (third-party UBE) except as may be approved by FCA under § 615.5140(e) for de minimis and passive investments. Such approvals would be considered outside of this rule.

As previously stated, this rule is not applicable to any UBEs that System institutions may establish as RBICs under their separate statutory authority. System institutions' activities under the RBIC authority must be carried out in accordance with the authority of and regulations issued by USDA.[7]

However, this rule does apply to System institutions that organize UBEs for the express purpose of investing in a RBIC.

2. Definitions [new § 611.1151]

We propose a definitions section in § 611.1151 that defines the following relevant terms used in the proposed rule.

Articles of Formation refers to the relevant State documents on the establishment, ownership, and operation of a UBE and includes registration certificates, charters, articles of organization, partnership agreements, membership or trust agreements, operating, administration or management agreements, fee agreements, or any other documentation on the establishment, ownership or operation of a UBE.

Control[8] distinguishes whether a System institution controls the business activities, operations, and actions of the UBE. Control means that one System institution, directly or indirectly, owns more than 50 percent of the UBE's equity or serves as the general partner[9] of an LLLP or constitutes the sole manager or is the managing member of a UBE. However, under generally accepted accounting principles (GAAP), the power to control may also exist with a lesser percentage of ownership, for example, if a System institution is the UBE's primary beneficiary; exercises significant influence over the UBE; or establishes control under other facts and circumstances in accordance with GAAP.

Under this definition, a System institution also will be deemed to have control over the UBE if it exercises decision-making authority in a principal capacity of the UBE as defined under GAAP.

A System institution must divest its ownership interest or withdraw as a member or partner from any UBE as soon as practicable if, after a System institution organizes or invests in a System-controlled UBE, non-System persons or entities obtain control as defined under GAAP. Alternatively, as soon as practicable the non-System persons or entities must relinquish control as defined under GAAP.

Equity investment means a System institution's contribution of money or assets to the operating capital of a UBE that provides ownership rights in return. The term is meant to include any such contribution of money or assets regardless of the terminology that might be used in an individual State's statute or regulations. The definition of equity investment does not include the costs of organizing a UBE, such as the cost of the articles of formation, attorney fees, filing fees, etc.

System institution refers to each System bank under titles I or III of the Act, each association under title II of the Act, and each service corporation chartered by FCA under section 4.25 of the Act.

Third-party UBE means any UBE that is owned or controlled by one or more non-System persons or entities.

UBE is an acronym for Unincorporated Business Entity. As defined for purposes of this proposed rule, the term "UBE" includes unincorporated business entities that are formally established and maintained through applicable State law, such as limited partnerships, limited liability companies, and business or other trust entities.

UBE Business Activity refers to the delivery of services or functions by a UBE for one or more System institutions.

3. Regulation, Examination, Enforcement, and Assessment Authority [new § 611.1152]

Proposed § 611.1152 affirms that FCA has full regulatory, supervisory, oversight, examination and enforcement authority over System institutions in connection with their equity investments in and control of UBEs and the services and functions that a UBE performs for the System institution. Such authority includes FCA's right to require a System institution to withdraw from a UBE through dissolution or disassociation or to divest of any investment in a UBE. Sections 5.17(a)(5), 5.17(a)(10), and 5.25(a) of the Act, as well as § 615.5354, also give FCA the authority to condition the approval of a System institution's equity investment in a UBE. The FCA's use of these authorities ensures that System institutions providing certain functions and services through State-organized or chartered UBEs remain safe and sound and operate in accordance with law and regulations.

Finally, this proposed section provides that the cost of regulating and examining equity investments in UBEs and the services and functions that UBEs can perform for System institutions will be subject to FCA's assessment authority under section 5.15 of the Act.

4. <u>General Restrictions and Prohibitions on the Use of UBEs</u> [new § 611.1153]

Proposed § 611.1153 sets forth certain general restrictions on any function, service or activity that a System institution(s) conducts through a UBE. These restrictions would ensure that the System continues to operate in a safe and sound manner and that its status as a cooperative system of lending institutions and a GSE is not jeopardized through the use of UBEs.

The first restriction would provide that any business a System institution conducts through a UBE must be necessary or expedient to the business of the System institution. A UBE cannot be used to deliver services or functions or to engage in any activity that a System institution itself could not engage in under the Act or implementing regulations.

A second restriction would protect the integrity of the System's cooperative structure by prohibiting System institutions from engaging in direct lending activities or from engaging in any other activity through the use of a UBE that would circumvent the application of cooperative principles, as determined by FCA, including borrower rights, stock ownership, voting rights or patronage.

A third restriction would ensure that the use of a UBE by a System institution is transparent to the public and free from conflicts of interest. This provision would require that a UBE be held out to the public as a separate or subsidiary entity; the business transactions, accounts and records of the UBE are not commingled with those of the System institution; and all transactions between officers, employees and agents of the UBE and a System institution are conducted at arm's length, in the interest of the System institution, and in compliance with the standards of conduct rules in 12 CFR part 612, subpart A.

A fourth restriction would limit a single System institution from conducting business through a one-member UBE, such as a limited liability company, other than for the limited purposes of: (1) Acquiring and managing unusual or complex collateral associated with loans, as set forth under the guidance of FCA Bookletter BL-057; and (2) providing electronic transaction, fixed asset, trustee or other similar services that are integral to the daily internal operations of System institutions.

We are proposing this limitation for a number of reasons. First, the Agency does not want to set in motion a proliferation of System-controlled UBEs organized for numerous purposes by a single System institution. Such a proliferation could create a costly administrative burden for the Agency and complicate FCA's oversight authority. Moreover, the creation of one-member UBEs does not foster System collaborative efforts aimed at providing more efficient System operations and improved services

to agriculture, agricultural producers, and rural America. Just as Congress encouraged System collaboration through the creation of the 4.25 service corporations, the use of UBEs would, generally, be reasonable and supportable from a business perspective when undertaken through System institution partnerships or multi-member limited liability companies. Finally, without reasonable and supportable reasons to form a UBE, including a one-member UBE, System institutions should conduct all aspects of their business activity either directly or through a service corporation under section 4.25 of the Act.

Regardless of the limitations on one-member UBEs, we recognize that the use of a UBE to perform services integral to a System institution's daily internal operations, as noted above, may lessen administrative burdens and reduce costs for a System institution. FCA may determine that some of these integral and internal services that a UBE, including a one-member UBE, could provide would become eligible for the notice provision in proposed § 611.1154. If so, we would inform System institutions of this development through an FCA Bookletter or other similar means.

We note that, under the agricultural credit association (ACA) structure, the ACA and its subsidiary production credit association (PCA) and Federal land credit association (FLCA) are treated by FCA as one entity for most regulatory purposes. Also, we note that an Agricultural Credit Bank (ACB) and its Farm Credit Bank (FCB) subsidiary are treated by FCA as a single entity for most regulatory purposes. Therefore, we would consider any UBE formed solely between an ACA and its subsidiary PCA and FLCA or an ACB and its subsidiary FCB as a one-member UBE (and not a multi-member UBE) that could be organized only for the limited purposes set forth above.

A fifth restriction would limit a UBE organized as a partnership to one that is established between or among two or more System institutions that do not have a common board of directors. An ACA and its PCA and FLCA subsidiaries, which operate under a common board of directors, are treated by FCA as one entity for most regulatory purposes, and could not create a partnership between or among themselves under this rule. Similarly, an ACB and its FCB subsidiary, also treated by FCA as one entity for most regulatory purposes, could not create a partnership between themselves.

A sixth restriction would prohibit one or more System institutions that organize or invest in a UBE from creating a subsidiary of the UBE, or enabling the UBE to create its own subsidiary or any other type of affiliated entity. This restriction is essential given FCA's obligations as an independent, safety and soundness regulator of a GSE. The complex arrangements that could possibly be established between System-owned or controlled UBEs and other special purpose vehicles currently permitted under various State laws could, as stated above, create a costly administrative burden for the Agency and complicate FCA's regulatory, examination, and enforcement oversight of the System's safety and soundness. For this reason, we are prohibiting System institutions from propagating additional subsidiaries or any other affiliated entities through their UBEs.

A seventh restriction requires that a System institution's liability be limited to the amount of the institution's equity investment in the UBE, thus preserving a significant benefit for the use of such a business structure — the concept of limited liability. Therefore, System institutions could not serve as a general partner in those UBEs organized as limited partnerships.

An eighth restriction would limit the aggregate amount of equity investments that a System institution is authorized to hold in all UBEs to one percent of the institution's total outstanding loans calculated at the time of each investment. The proposed rule allows FCA to approve an exception to this limitation on a case-by-case basis. In addition, FCA may impose a limitation that is lower than the one-percent aggregate limit based on safety or soundness and other relevant concerns. We believe this limit to be reasonable given that such an investment imposes a financial liability on a System institution

up to the amount of its total investments in UBEs. Such an investment remains at-risk; it is recovered only after the System institution sells its interest to other investors or the UBE owners receive some of the proceeds from the liquidated assets of the UBE (if any such proceeds remain after satisfying all other obligations of the UBE). To calculate the investment limit under proposed § 611.1153(h), the rule would require that equity investments held by a service corporation be attributed to its System institution bank and association owners based on their percentage of ownership of the service corporation. This limit would not apply to equity investments made in one-member UBEs organized to acquire and manage unusual or complex collateral associated with loans.

The ninth restriction prohibits a System institution from making any equity investment in a third-party UBE except as may be authorized by FCA on a case-by-case basis under § 615.5140(e) for de minimis and passive investment purposes (such requests would be considered outside of this rule). Also, a System institution is prohibited from being named as the general partner, manager or primary beneficiary of a third-party UBE. Such arrangements have the potential to subject a System institution to liability and reputational risks created by the third-party UBE and to result in actual or apparent conflicts of interest that neither a System institution nor FCA could adequately control. Finally, such arrangements could dilute the Agency's oversight of System activities and diminish FCA's ability to ensure the safety and soundness of the System.

A final restriction would prohibit non-System entities or persons from holding any equity interest in a System-controlled UBE with one exception. Non-System entities or persons would be able to hold up to 20 percent of the equity of a System-controlled UBE that is organized to provide services integral to the daily internal operations of a System institution. This percentage of non-System ownership is the same non-System ownership percentage that FCA regulations currently permit for service corporations organized by one or more System institutions under section 4.25 of the Act. The ninth and final restrictions do not apply to UBEs formed for the purpose of acquiring and managing unusual or complex collateral associated with multiple-lender loan transactions in which non-System persons or entities are participants.

5. Notice-Only Requirement for Certain UBE Equity Investments [§ 611.1154]

In proposed § 611.1154, we describe the specific types of UBEs that a System institution may organize or invest in by providing sufficient advance notice to the FCA. This section also sets forth the specific information that a System institution must include in its notice as well as where the notice must be filed.

This "notice-only" provision would be limited to the following UBEs:

a. Those engaged in acquiring and managing the unusual or complex collateral associated with loans as described in FCA Bookletter BL-057, dated April 2, 2009; and

b. Those providing hail or multi-peril crop insurance services in accordance with § 618.8040.

FCA may determine that other UBE business activity is also appropriate for this "notice-only" provision and, in such an event, would notify all System institutions by bookletter or other means. Only System institutions with a composite FIRS rating of 1 or 2 would qualify for the "notice-only" provision. All other System institutions that intend to form or invest in a UBE must obtain FCA's prior approval under the provisions in § 611.1155 regardless of the nature or purpose of the intended UBE.

A System institution that qualifies for the "notice-only" provision would be required to submit

articles of formation as defined in § 611.1151 that address basic information on the UBE's ownership, control, and operations. The System institution would also need to specify the dollar amount of its investment in the UBE and provide a certified resolution from its board of directors that the board has authorized the UBE investment and business activity and has given its approval to submit the notice to FCA. A letter from the funding bank that the bank has approved such investment would also be required. For those System institutions forming a UBE for hail or multi-purpose crop insurance services, or for other UBE activity that FCA determines appropriate for the "notice-only" provision, the notice would need to include a statement from the board of directors explaining the operating efficiencies and benefits to be gained from the conduct of business through a UBE. The statement must also affirm that the UBE is necessary or expedient to the institution's business; that it will operate with transparency; that it will operate in a manner that prevents conflicts of interest between the UBE and the institution itself; that the UBE will comply with all applicable Federal, State, and local laws; and that the UBE will not be used by the System institution to make direct loans, perform any functions, or provide any services that the System institution is not authorized to provide under the Act and FCA regulations or that go beyond the stated purpose of the UBE. FCA may require additional information under the notice provision or allow the omission of some information. Finally, System institutions that organize or invest in UBEs under this "notice-only" provision must comply with the ongoing requirements and disclosure and reporting requirements of §§ 611.1156 and 611.1157, respectively.

6. Approval Process [new § 611.1155]

In § 611.1155, we describe the documents that FCA would require to review a request for approval to organize or invest in a UBE if the request would not qualify for the "notice-only" provision in § 611.1154. We would ask a System institution to explain the risk characteristics of the investment, the initial amount of equity it plans to invest in the UBE, the purpose of the UBE, and its objectives. A System institution must provide support for its need to establish or invest in a UBE. We would also ask for a statement on the operating efficiencies that the System institutions expect to achieve and the benefits they expect to derive from using the UBE. A System institution would be required to submit the articles of formation defined in § 611.1151 that address basic information on the UBE's ownership, management structure, and operations. We would also require a certified resolution of the institution's board of directors approving the equity investment in the UBE and the UBE's business activity as well as a letter from the funding bank that it has approved the institution's investment in the UBE. In addition, we would require that an institution's board of directors provide us with a statement that the UBE is necessary or expedient to the institution's business; that it will operate with transparency; that it will operate in a manner that prevents conflicts of interest between the UBE and the institution itself; that the UBE will comply with all applicable Federal, State, and local laws; and that the UBE will not be used by the System institution to make direct loans, perform any functions, or provide any services that the System institution is not authorized to provide under the Act and FCA regulations or that go beyond the stated purpose of the UBE. The institutions may also submit any other information they deem necessary. FCA may require additional information or allow the omission of some information depending on the complexity of the UBE request. If FCA denies approval of the request, we will specify in writing our reasons for denial.

7. Ongoing Requirements [new § 611.1156]

Any System institution that organizes or invests in a UBE for the delivery of services or functions under the provisions of this rule would be expected to maintain and ensure FCA's access to all documents and records of the UBE. Also, a System institution would need to be prepared to divest its ownership interest or withdraw as a member or partner from any UBE that conducts activities beyond its approved limited purpose or that are contrary to the Act or FCA regulations. Under the proposed rule, if the FCA

directed the System institution to divest its equity investment in, or withdraw as a member, partner, general partner, managing member or primary beneficiary of, a System-owned and controlled UBE, the institution would be required to do so as soon as practicable.

If a System institution fails to divest its equity investment in, or withdraw as a member, partner, general partner, managing member or primary beneficiary of, a System-owned and controlled UBE, as directed by the FCA within a reasonable period of time, such institution may be subject to an enforcement action pursuant to FCA's enforcement authority under part C of title V of the Act.

8. <u>Disclosure and Reporting Requirements</u> [§ 611.1157]

All System institutions that hold equity investments in UBEs would be required to include information about their equity investments and business activities in their annual reports to shareholders. We propose amending § 620.5, which prescribes the content of the annual report to shareholders, to include this requirement. FCA could also direct that System institutions holding equity investments in UBEs make periodic reports to FCA as required by § 621.12.

System institutions with UBEs that are grandfathered under the rule through the provision in § 611.1158 (discussed below) would be subject to the ongoing requirements of § 611.1156 and all disclosure and reporting requirements of § 611.1157.

We also propose that a System institution dissolving a UBE that it controls be required to provide a timely report to FCA when the dissolution occurs. This reporting will enable FCA to have current information on the status of UBE activity.

9. <u>Grandfather Provision</u> [new § 611.1158]

We propose grandfathering from the Notice and Approval provisions of the rule a System institution's organization of, or investment in, a UBE that received specific, written approval by FCA prior to the date this proposed rule would become effective as a final rule. We would also grandfather those UBEs organized pursuant to the guidance in FCA Bookletter BL-057. All System institutions grandfathered would remain subject to the conditions of approval imposed at the time of FCA's approval and be subject to the ongoing requirements of § 611.1156 and the disclosure and reporting requirements of § 611.1157. System institutions so grandfathered could not change or expand the UBE business activity, ownership interests in, or control of the UBE without providing notice to FCA at least 20 business days in advance of any change. If FCA determined that the proposed change or expansion is material, it could require the System institutions to submit a new approval request under § 611.1155.

B. <u>Other Miscellaneous Changes</u>

We propose conforming changes to various FCA regulatory sections to delete terms made obsolete by a final UBE rule and to add new regulatory sections cross-referenced in this proposed regulation.

<u>Regulatory Flexibility Act</u>

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 <u>et</u> <u>seq</u>.), the FCA hereby certifies that the proposed rule would not have a significant economic impact on a substantial number of small entities. Each of the banks in the Farm Credit System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small

entities. Therefore, Farm Credit System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

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[1]Sections 1.5(15) and 3.1(13)(A) of the Act set forth the investment authorities for System banks. Sections 2.2(10) and 2.12(18) of the Act set forth the investment authorities for System associations. FCA regulations in subpart E of part 615 imbue service corporations, chartered under section 4.25 of the Act, with the same investment authorities as their organizing System banks and associations.

[2]Sections 1.5(3), (15) and (21); 2.2(3), (10) and (20); 2.12(3), (18) and (19); 3.1(3) and (16) of the Act.

[3]Section 4.25 and 4.28(A), added to the Act in 1980, expressly authorize System banks and associations to organize service corporations. Congress stated that this authority was needed to provide a more efficient way for System banks to coordinate services. Service corporations, like System banks and associations, are federally chartered instrumentalities and subject to the same FCA supervisory, regulatory and enforcement oversight as System banks and associations. Service corporations are authorized to provide the same functions and services as banks and associations with two significant exceptions: they cannot extend credit or provide insurance services.

[4]Section 4.19 of the Act.

[5]This perspective is noted in the FCA Board's Policy Statement (FCA-PS-80) on Cooperative Operating Philosophy—Serving the Members of Farm Credit System Institutions, dated October 14, 2010, and published in the Federal Register at 75 FR 64728 on October 20, 2010.

[6]FCA Bookletter BL-057 on "Use of State-Chartered Business Entities to Hold Acquired Property," dated April 2, 2009, provides guidance on the System's use of UBEs to acquire and manage unusual or complex collateral associated with loans.

[7]Pub. L. 107-171, title VI, sec. 6029 (2002), as amended by the Food, Conservation, and Energy Act of 2008, Pub. L. 110-246, title VI, sec. 6027, and USDA regulations at 7 CFR 4290.10 through 4290.3099. FCA has the authority to ensure that a System institution's investment in a RBIC is safe and sound and that they operate the RBIC in accordance with law and regulation.

[8]The term control as it is used in the context of this proposed rule is based on the guidance provided in Generally Accepted Accounting Principles (GAAP) under the Financial Accounting Standards Board's Accounting Standards Codification (ASC). See primary discussion of control at ASC 810-10-15 and ASC 810-10-25; significant influence over an investment at ASC 323-10-15; and control for limited partnerships and similar entities, including LLCs, etc. at ASC 810-20-25. See also proposed Accounting Standards Update 2011-220 for possible revisions to these sections.

[9]The rule would allow a System institution to serve as a general partner of an LLLP, but not an LP, since the liability for the partnership's debts and obligations is limited to the amount invested by the general partner in an LLLP but not in an LP. We note that an LLP does not have a general partner because all partners in an LLP have limited liability.

List of Subjects

12 CFR Part 604

Sunshine Act.

12 CFR Part 611

Agriculture, Banks, banking, Rural areas.

12 CFR Part 612

Agriculture, Banks, banking, Conflict of interests, Crime, Investigations, Rural areas.

12 CFR Part 619

Agriculture, Banks, banking, Rural areas.

12 CFR Part 620

Accounting, Agriculture, Banks, banking, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 621

Accounting, Agriculture, Banks, banking, Penalties, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 622

Administrative practice and procedure, Crime, Investigations, Penalties.

12 CFR Part 623

Administrative practice and procedure.

12 CFR Part 630

Accounting, Agriculture, Banks, banking, Organization and functions (Government agencies), Reporting and recordkeeping requirements, Rural areas.

For the reasons stated in the preamble, parts 604, 611, 612, 619, 620, 621, 622, 623, and 630 of chapter VI, title 12 of the Code of Federal Regulations are proposed to be amended as follows:

PART 604--FARM CREDIT ADMINISTRATION BOARD MEETINGS

1. The authority citation for part 604 continues to read as follows:

Authority: Secs. 5.9, 5.17 of the Farm Credit Act (12 U.S.C. 2243, 2252).

§ 604.420 [Amended]

2. Section 604.420 is amended by removing the words "service organizations" in paragraph (i)(1) and adding in their place, the words "service corporations chartered under the Act."

PART 611--ORGANIZATION

3. The authority citation for part 611 is revised to read as follows:

Authority: Secs. 1.2, 1.3, 1.4, 1.5, 1.12, 1.13, 2.0, 2.1, 2.2, 2.10, 2.11, 2.12, 3.0, 3.1, 3.2, 3.3, 3.7, 3.8, 3.9, 3.21, 4.3A, 4.12, 4.12A, 4.15, 4.20, 4.21, 4.25, 4.26, 4.27, 4.28A, 5.9, 5.17, 5.25, 7.0-7.13, 8.5(e) of the Farm Credit Act (12 U.S.C. 2002, 2011, 2012, 2013, 2020, 2021, 2071, 2072, 2073, 2091, 2092, 2093, 2121, 2122, 2123, 2124, 2128, 2129, 2130, 2142, 2154a, 2183, 2184, 2203, 2208, 2209, 2211, 2212, 2213, 2214, 2243, 2252, 2261, 2279a-2279f-1, 2279aa-5(e)); secs. 411 and 412 of Pub. L. 100-233, 101 Stat. 1568, 1638; sec. 414 of Pub. L. 100-399, 102 Stat. 989, 1004.

§ 611.1130 [Amended]

4. Section 611.1130 is amended in the first sentence of paragraph (a) by removing the words "service organizations organized under the Act" and adding in their place, the words "service corporations chartered under the Act".

5. Amend Part 611 by revising the heading of subpart I to read as follows:

Subpart I--Service Corporations

§ 611.1136 [Amended]

6. Section 611.1136 is amended by:
a. Revising the heading of § 611.1136;
b. Removing the words "and unincorporated service organizations" in paragraph (c); and
c. Removing the words "service organizations" each place they appear and adding in their place, the words "service corporations".
The revision reads as follows:

§ 611.1136 Regulation and examination of service corporations.

7. Part 611 is amended by adding a new subpart J, consisting of §§ 611.1150 through 611.1158, to read as follows:

Subpart J--Unincorporated Business Entities

Sec.

611.1150 Purpose and scope.
611.1151 Definitions.
611.1152 Authority over equity investments in UBEs for business activity.
611.1153 General restrictions and prohibitions on the use of UBEs.
611.1154 Notice of equity investments in UBEs.
611.1155 Approval of equity investment in UBEs.
611.1156 Ongoing requirements.
611.1157 Disclosure and reporting requirements.
611.1158 Grandfather provision.

§ 611.1150 Purpose and scope.

(a) *Purpose.* This subpart sets forth the parameters for one or more Farm Credit System (System) institutions to organize or invest in an Unincorporated Business Entity (UBE) in accordance with the Farm Credit Act of 1971, as amended (Act).

(b) *Scope.* Except as authorized under these regulations, no System institution may manage,

control, become a member or partner, or invest in a State-organized or chartered business entity. This rule applies to each System institution that organizes or invests in a UBE, including a UBE organized for the express purpose of investing in a Rural Business Investment Company. This rule does not apply to UBEs that one or more System institutions have the authority to establish as Rural Business Investment Companies pursuant to the provisions of title VI of the Farm Security and Rural Investment Act of 2002, as amended (FSRIA) and United States Department of Agriculture regulations implementing FSRIA.

§ 611.1151 Definitions.

For purposes of this subpart, the following definitions apply:

Articles of formation means registration certificates, charters, articles of organization, partnership agreements, membership or trust agreements, operating, administration or management agreements, fee agreements or any other documentation on the establishment, ownership, or operation of a UBE.

Control means that one System institution, directly or indirectly, owns more than 50 percent of the UBE's equity or serves as the general partner of an LLLP, or constitutes the sole manager or the managing member of a UBE. However, under generally accepted accounting principles (GAAP), the power to control may also exist with a lesser percentage of ownership, for example, if a System institution is the UBE's primary beneficiary, exercises significant influence over the UBE or establishes control under other facts and circumstances in accordance with GAAP. Under this definition, a System institution also will be deemed to have control over the UBE if it exercises decision-making authority in a principal capacity of the UBE as defined under GAAP.

Equity investment means a System institution's contribution of money or assets to the operating capital of a UBE that provides ownership rights in return.

System institution means each System bank under titles I or III of the Act, each System association under title II of the Act, and each service corporation chartered under section 4.25 of the Act.

Third-party UBE means a UBE that is owned or controlled by one or more non-System persons or entities as the term "control" is defined under GAAP.

UBE means a Limited Partnership (LP), Limited Liability Partnership (LLP), Limited Liability Limited Partnership (LLLP), Limited Liability Company (LLC), Business or other Trust Entity (TE), or other business entity established and maintained under State law that is not incorporated under any law or chartered under Federal law.

UBE business activity means the services and functions delivered by a UBE for one or more System institutions.

§ 611.1152 Authority over equity investments in UBEs for business activity.

(a) *Regulation, supervisory, oversight, examination and enforcement authority*. FCA has regulatory, supervisory, oversight, examination and enforcement authority over each System institution's equity investment in or control of a UBE and the services and functions that a UBE performs for the System institution. This includes FCA's authority to require a System institution's dissolution of, disassociation from, or divestiture of an equity investment in a UBE, or to otherwise condition the approval of equity investments in UBEs.

(b) *Assessing UBE investments and business activity*. In accordance with section 5.15 of the Act and § 607.2(h), the cost of regulating and examining equity investments in UBEs and the services and functions that UBEs can perform for System institutions will be taken into account when assessing a System institution for the cost of administering the Act.

§ 611.1153 General restrictions and prohibitions on the use of UBEs.

(a) *Authorized UBE business activity*. All UBE business activity must be:

(1) Necessary or expedient, as determined by the FCA, to the business of one or more System institutions owning the UBE; and

(2) In no instance greater than the functions and services that one or more System institutions

owning the UBE are authorized to perform under the Act and as determined by the FCA.

(b) *Circumvention of cooperative principles*. System institutions are prohibited from using UBEs to engage in direct lending activities or any other activity that would circumvent the application of cooperative principles as determined by FCA, including borrower rights as described in section 4.14A of the Act, or stock ownership, voting rights or patronage as described in section 4.3A of the Act.

(c) *Transparency and the avoidance of conflicts of interest*. Each System institution must ensure that:

(1) The UBE is held out to the public as a separate or subsidiary entity;

(2) The business transactions, accounts, and records of the UBE are not commingled with those of the System institution; and

(3) All transactions between the UBE and System institution directors, officers, employees, and agents are conducted at arm's length, in the interest of the System institution, and in compliance with standards of conduct rules in §§ 612.2130 through 612.2270.

(d) *Limit on one-member UBEs*. A UBE owned solely by a single System institution (including between and among a parent agricultural credit association and its production credit association and Federal land credit association subsidiaries and between a parent agricultural credit bank and its subsidiary Farm Credit Bank) as a one-member UBE is limited to the following special purposes:

(1) Acquiring and managing the unusual or complex collateral associated with loans; and

(2) Providing limited services such as electronic transaction, fixed asset, trustee or other services that are integral to the daily internal operations of a System institution.

(e) *Limit on UBE partnerships*. A System institution operating through a parent-subsidiary structure may not create a UBE partnership between or among the parent agricultural credit association and its production credit association and Federal land credit association subsidiaries or between a parent Agricultural Credit Bank and its Farm Credit Bank subsidiary.

(f) *Prohibition on UBE subsidiaries*. A System institution is prohibited from creating a subsidiary of a UBE that it has organized or invested in under this subpart or from enabling the UBE itself to create a subsidiary or any other type of affiliated entity.

(g) *Limit on potential liability*.

(1) Each System institution's equity investment in a UBE must be established in a manner that will limit potential exposure of the System institution to no more than the amount of its investment in the UBE.

(2) A System institution cannot become a general partner of any partnership other than an LLLP.

(h) *Limit on amount of equity investment in UBEs*. The aggregate amount of equity investments that a single System institution is authorized to hold in UBEs must not exceed one percent of the institution's total outstanding loans, calculated at the time of each investment. On a case-by-case basis, FCA may approve an exception to this limitation that would exceed the one-percent aggregate limit. Conversely, FCA may impose a percentage limit lower than the one-percent aggregate limit based on safety or soundness and other relevant concerns. This one-percent aggregate limit does not apply to equity investments in one-member UBEs as permitted in paragraph (d)(1) of this section. Any equity investment made in a UBE by a service corporation must be attributed to its System institution owners based on the ownership percentage of each bank or association.

(i) *Prohibition on relationship with a third-party UBE*. A System institution is prohibited from:

(1) Making any equity investment in a third-party UBE except as may be authorized on a case-by-case basis under § 615.5140(e) for de minimis and passive investments. Such requests would be considered outside of this rule.

(2) Serving as the general partner or manager of a third-party UBE; or

(3) Being designated as the primary beneficiary of a third-party UBE, either alone or with other System institutions.

(j) *Limitation on non-System equity investments.*

Non-System persons or entities may not invest in a UBE that is controlled by a System institution except that non-System persons or entities may own 20 percent or less of the equity of a System-controlled UBE organized to deliver services integral to the daily internal operations of a System institution.

(k) *UBEs formed for acquiring and managing collateral*. The provisions of paragraphs (i) and (j) in this section do not apply to UBEs formed for the purpose of acquiring and managing unusual or complex collateral associated with multiple-lender loan transactions in which non-System persons or entities are participants.

§ 611.1154 Notice of equity investments in UBEs.

(a) *Applicability*. This notice provision is applicable only to System institutions that have a composite Financial Institution Rating System (FIRS) rating of 1 or 2 and wish to make an equity investment in UBEs whose activities are limited to the following purposes:

(1) Acquiring and managing unusual or complex collateral associated with loans;

(2) Providing hail or multi-peril crop insurance services in collaboration with another System institution in accordance with § 618.8040; and

(3) Any other UBE business activity that FCA determines to be appropriate for this "notice-only" provision.

(b) *Notice requirements*. A System institution must provide reasonable written notice to FCA. System institutions are encouraged to submit such notice as soon as possible, but it must be submitted no later than 20 business days in advance of making an equity investment in a UBE for authorized UBE business activity described in paragraph (a) of this section. The notice must include:

(1) The UBE's articles of formation, including its name and the State in which it is organized, length of time it will exist, its partners or members, and its management structure;

(2) The dollar amount of the System institution's equity investment in the UBE;

(3) A certified resolution of the System institution's board of directors authorizing the equity investment in, and business activity of, the UBE and the board's approval to submit the notice to the FCA;

(4) A letter from the funding bank that it has approved the institution's equity investment in the UBE;

(5) For those UBEs identified in paragraphs (a)(2) and (3) of this section, a detailed statement from the System institution's board of directors that the UBE:

(i) Is needed to achieve operating efficiencies and benefits;

(ii) Is necessary or expedient to the System institution's business;

(iii) Will operate with transparency;

(iv) Will conduct its business activity in a manner designed to prevent conflicts of interest between its purpose and operations and the mission and operations of the System institution(s);

(v) Will otherwise be in compliance with applicable Federal, State, and local laws; and

(vi) Will not be used by the System institution to make direct loans; perform any functions or provide any services that the System institution is not authorized to perform or provide under the Act and FCA regulations; or to exceed the stated purpose of the UBE as set forth in its articles of formation.

(6) Any additional information the System institution wishes to submit.

(c) *Supplementation or omission of information*. FCA may require the supplementation or allow the omission of any information required under paragraph (b) of this section.

(d) *Other requirements*. All System institutions under this "notice-only" provision must also comply with the ongoing requirements and disclosure and reporting requirements set forth in §§ 611.1156 and 611.1157, respectively, of this subpart.

§ 611.1155 Approval of equity investments in UBEs.

(a) *Request*. System institutions must receive FCA approval before organizing or investing in any UBE that does not qualify for the "notice-only" provision set forth in § 611.1154 of this subpart.

A request for approval under this section must include the following information:

(1) A detailed statement of the risk characteristics of the investment, as required by § 615.5140(e) and the initial amount of equity investment;

(2) A detailed statement on the purpose and objectives of the UBE; the need for the UBE and the operating efficiencies and benefits that will be achieved by using the UBE;

(3) The proposed articles of formation addressing, at a minimum, the following:

(i) The UBE's name, the State in which it is organized, the city and State in which its principal office is to be located, and its partners or members; and management structure;

(ii) Specific business activities that the UBE will conduct;

(iii) General powers of the UBE;

(iv) Ownership, voting, partnership, membership and operating agreements for the UBE;

(v) Procedures to adopt and amend the partnership, membership or operating agreement of the UBE;

(vi) The standards and procedures for the application and distribution of the UBE's earnings; and

(vii) Length of time the UBE will exist.

(4) A certified resolution of the System institution's board of directors authorizing the equity investment in the UBE and the UBE business activity and the board's approval to submit the request to the FCA.

(5) A letter from the funding bank that it has approved the institution's equity investment in the UBE;

(6) A statement from the System institution's board of directors that the UBE:

(i) Is necessary or expedient to the System institution's business;

(ii) Will operate with transparency;

(iii) Will conduct its business activity in a manner designed to prevent conflicts of interest between its purpose and operations and the mission and operations of the System institution(s);

(iv) Will comply with applicable Federal, State, and local laws; and

(v) Will not be used by the System institution to make direct loans; perform any functions or provide any services that the System institution is not authorized to perform or provide under the Act and FCA regulations; or exceed the purpose of the UBE as stated in its articles of formation.

(7) Any additional information the System institution wishes to submit or any other supporting documentation that FCA may request.

(b) *Supplementation or omission of information*. FCA may require the supplementation or allow the omission of any information required under paragraph (a) of this section based on the complex or noncomplex nature of the proposed UBE.

(c) *Denial of a request*. The FCA will specify in writing to the submitting System institutions the reasons for denial of any request to organize or invest in a UBE.

§ 611.1156 Ongoing requirements.

A System institution that makes an equity investment in a UBE under §§ 611.1154 or 611.1155 of this subpart must also comply with the following requirements:

(a) Maintain and ensure FCA's access to all books, papers, records, agreements, reports and other documents of each UBE necessary to document and protect the institution's interest in each entity;

(b) Divest, as soon as practicable, the institution's equity or beneficial interest in (or withdraw membership from) any UBE that conducts activities beyond those authorized to carry out its limited purpose or that are contrary to the Act or FCA regulations; and

(c) Divest the institution's respective ownership or managerial duties in the UBE as soon as practicable, if directed to do so by FCA.

(d) Divest the institution's ownership interest or withdraw as a member or partner from any UBE as soon as practicable if, after a System institution organizes or invests in a System-controlled UBE, non-System persons or entities obtain control as defined under GAAP. Alternatively, as soon as

practicable, the non-System persons or entities must relinquish control as defined under GAAP. This paragraph does not apply to UBEs formed for the purpose of acquiring and managing unusual or complex collateral associated with multiple-lender loan transactions in which non-System persons or entities are participants.

§ 611.1157 Disclosure and reporting requirements.

(a) *Annual report to shareholders*. In its annual report to shareholders, as set forth in § 620.5(a)(12), a System institution must provide information on its UBE investment and business activity.

(b) *Periodic reports as directed*. As directed by FCA, a System institution may be required to submit periodic reports to FCA on any equity investment in a UBE or UBE status as provided under § 621.12, and in accordance with §§ 621.13 and 621.14.

(c) *Dissolution of a UBE*. A System institution must submit a timely report to FCA on the dissolution of a UBE that it controls.

§ 611.1158 Grandfather provision.

(a) *Scope*. The following equity investments in UBEs are grandfathered from the Notice and Approval provisions under §§ 611.1154 and 611.1155, respectively, of this subpart.

(1) Those UBE formations or equity investments that received specific, written approval by FCA prior to the effective date of this regulation; and

(2) Those UBEs organized to acquire or manage unusual or complex collateral associated with loans.

(b) *System institutions' obligations*. All System institutions with grandfathered UBEs:

(1) Remain subject to their conditions of approval;

(2) Are subject to the ongoing requirements of § 611.1156 and the disclosure and reporting requirements of § 611.1157 of this subpart; and

(3) May not change or expand the UBE business activity, ownership interests in, or control of the UBE without providing notice of such changes to FCA at least 20 business days in advance of any change or expansion. If the proposed change or expansion is determined to be material, FCA may require the System institution(s) to submit an "Approval" request under § 611.1155 of this subpart.

PART 612--STANDARDS OF CONDUCT AND REFERRAL OF KNOWN OR SUSPECTED CRIMINAL VIOLATIONS

8. The authority citation for part 612 continues to read as follows:

Authority: Secs. 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2243, 2252, 2254).

9. Section 612.2130 is amended by revising paragraphs (p) and (t) to read as follows:

§ 612.2130 Definitions.

* * * * *

(p) *Service corporation* means each service corporation chartered under the Act.

* * * * *

(t) *System institution* and *institution* mean any bank, association, or service corporation in the Farm Credit System, including the Farm Credit Banks, banks for cooperatives, Agricultural Credit Banks, Federal land bank associations, agricultural credit associations, Federal land credit associations, production credit associations, the Federal Farm Credit Banks Funding Corporation, and service corporations chartered under the Act.

PART 619--DEFINITIONS

10. The authority citation for part 619 is revised to read as follows:

Authority: Secs. 1.4, 1.5, 1.7, 2.1, 2.2, 2.4, 2.11, 2.12, 3.1, 3.2, 3.21, 4.9, 5.9, 5.17, 5.19, 7.0, 7.1 , 7.6, 7.8, and 7.12 of the Farm Credit Act (12 U.S.C. 2012, 2013, 2015, 2072, 2073, 2075, 2092, 2093, 2122, 2123, 2142, 2160, 2243, 2252, 2254, 2279a, 2279a-1, 2279b, 2279c-1, 2279f); sec. 514 of Pub. L. 102-552, 106 Stat. 4102.

11. Part 619 is amended by adding a new § 619.9338 to read as follows:

§ 619.9338 Unincorporated business entities.

An *Unincorporated Business Entity* means a Limited Partnership (LP), Limited Liability Partnership (LLP), Limited Liability Limited Partnership (LLLP), Limited Liability Company (LLC), Business or other Trust Entity (TE), or other business entity established and maintained under State law that is not incorporated under any law or chartered under Federal law.

PART 620--DISCLOSURE TO SHAREHOLDERS

12. The authority citation for part 620 is revised to read as follows:

Authority: Secs. 4.3, 4.3A, 4.19, 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2154, 2154a,2207, 2243, 2252, 2254); sec. 424 of Pub. L. 100-233, 101 Stat. 1568, 1656; sec. 514 of Pub. L. 102-552, 106 Stat. 4102.

13. Section 620.5 is amended by:

a. Removing the words "service organization" in paragraph (a)(3) and adding in their place, the words "service corporation chartered under the Act"; and

b. Adding a new paragraph (a)(11) to read as follows:

§ 620.5 Contents of the annual report to shareholders.

* * * * *

(a) * * *

(11) For banks and associations, business relationships with unincorporated business entities (UBEs).

(i) Except as provided in § 620.5(a)(12)(ii) of this section, describe the business relationship with any UBE, as defined in § 611.1151, that was organized by the bank or association or in which the bank or association has an equity interest. Include in the description the name of the UBE, the type of business entity, the purpose for which the UBE was organized, the scope of its activities, and the level of ownership. If the bank or association does not have an equity interest, but manages the operations of a UBE that is controlled by a System institution, describe this business relationship and any fees received.

(ii) If the UBE is a one-member UBE as described in § 611.1153(d)(1), the bank or association need only disclose the name of the UBE, the type of business entity, and the purpose for which the UBE was organized.

* * * * *

PART 621--ACCOUNTING AND REPORTING REQUIREMENTS

14. The authority citation for part 621 continues to read as follows:

Authority: Secs. 5.17, 8.11 of the Farm Credit Act (12 U.S.C. 2252, 2279aa-11); sec. 514 of

Pub. L. 102-552.

§ 621.1 [Amended]

15. Section 621.1 is amended by removing the words "service organizations" and adding in their place, the words "service corporations".

§ 621.2 [Amended]

16. In § 621.2 paragraph (e) is amended by removing the words "service organization" and adding in their place, the words "service corporation."

PART 622—RULES OF PRACTICE AND PROCEDURE

17. The authority citation for part 622 continues to read as follows:

Authority: Secs. 5.9, 5.10, 5.17, 5.25-5.37 of the Farm Credit Act (12 U.S.C. 2243, 2244, 2252, 2261-2273); 28 U.S.C. 2461 note; and 42 U.S.C. 4012a(f).

§ 622.2 [Amended]

18. In § 622.2 paragraph (d) is amended by removing the words "service organization chartered under part E of title IV of the Act" and adding in their place, the words "service corporation chartered under the Act."

PART 623—PRACTICE BEFORE THE FARM CREDIT ADMINISTRATION

19. The authority citation for part 623 is revised to read as follows:

Authority: Secs. 5.9, 5.10, 5.17, 5.25—5.37 of the Farm Credit Act (12 U.S.C. 2243, 2244, 2252, 2261-2273).

§ 623.2 [Amended]

20. In § 623.2 paragraph (d) is amended by removing the words "service organization chartered under part E of title IV of the Act" and adding in their place, the words "service corporation chartered under the Act."

PART 630—DISCLOSURE TO INVESTORS IN SYSTEM-WIDE AND CONSOLIDATED BANK DEBT OBLIGATIONS OF THE FARM CREDIT SYSTEM

21. The authority citation for part 630 is revised to read as follows:

Authority: Secs. 4.2, 4.9, 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2153, 2160, 2243, 2252, 2254); sec. 424 of Pub. L. 100-233, 101 Stat. 1568, 1656; sec. 514 of Pub. L. 102-552, 106 Stat. 4102.

§ 630.20 [Amended]

22. Section 630.20 is amended by removing the words "service organization" in paragraph (a)(2)

and adding in their place, the words "service corporation."

Date: September 6, 2012

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.

69 FR 12694, 03/17/2004

Handbook Mailing HM-04-5

[6705-01-P]

FARM CREDIT ADMINISTRATION

Systematic Collection of Standardized Loan Data

AGENCY: Farm Credit Administration.

ACTION: Notice with request for comment.

SUMMARY: The Farm Credit Administration (FCA or agency) is seeking public input on the changes it should consider making to its systematic collection of standardized loan data. The agency currently collects basic descriptive information from Farm Credit System (FCS or System) banks and associations, in a standardized format, using the Loan Account Reporting System–Modified (LARS-M). The agency is planning to reengineer its collection of standardized loan data to meet its current and future information needs. In support of this reengineering project, FCA is seeking public comment on changes the agency should consider making to the loan data it collects; what processes and technological approaches to employ when collecting loan data; how to minimize the reporting burden on System institutions while meeting agency needs; and what types of standardized reports to make available to the general public and System institutions.

DATES: Please send your comments to the FCA by May 3, 2004.

ADDRESSES: We encourage you to send comments by electronic mail to "reg-comm@fca.gov" or through the Pending Regulations section of FCA's Web site, "www.fca.gov." You may also send comments to Andrew Jacob, Assistant Director, Office of Policy and Analysis, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090 or by facsimile to (703) 734-5784. You may review copies of all comments we receive at our office in McLean, Virginia.

FOR FURTHER INFORMATION CONTACT:

Gaylon J. Dykstra, Policy Analyst, Office of Policy and Analysis, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4073, TTY (703) 883-4434.

or

Howard Rubin, Senior Attorney, Office of the General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4029, TTY (703) 883-2020.

SUPPLEMENTARY INFORMATION:

I. <u>Background</u>

A. What is LARS-MLoan Data Does FCA Collect?

FCA currently collects certain standardized loan information from FCS banks and associations using the LARS-M. Examples of standardized variables collected include:

1. The date the loan was originated and the date on which it matures;

2. The primary agricultural commodity produced by the borrower;

3. Whether a loan is covered by a government guarantee;

4. If a loan is past due, the number of days the loan payment is delinquent;

5. The risk of the loan based on the uniform classification system as defined in the FCA Examination Manual (EM-320); and

6. Whether the borrower is in bankruptcy or the loan is in foreclosure status.

The agency also obtains direct institution-specific loan data as needed for examination purposes.

B. How Does FCA Use Loan Data?

FCA uses loan information to support its supervision and regulation of System institutions. For supervisory purposes, loan information is important for evaluating portfolio risk associated with agricultural lending and analyzing credit risks in individual agricultural loans. Loan data are also required for monitoring Systemwide trends and emerging vulnerabilities. For regulatory purposes, loan information is used for developing regulations and other public policy actions. FCA also uses loan data in fulfilling reporting requirements and informational requests.

C. Identifying Loan Portfolio Risk

Identification of risks in a loan portfolio is essential to FCA's evaluation of an institution's safety and soundness. Loan portfolio risk reflects individual loan exposures and the combined effects on a portfolio. Risk in individual loans is a function of characteristics associated with a borrower's agricultural operation and financial condition and performance. Examples of loan characteristics include the commodities produced, geographic location, payment history, financial strength, and off-farm income. These types of loan data are important determinants of the credit risk of a loan. Therefore, FCA access to loan data is critical for evaluating portfolio risks of System institutions and the credit risk of individual loans.

D. Monitoring Systemwide Trends

Analyzing Systemwide trends and emerging vulnerabilities is a critical agency activity for monitoring the overall mission accomplishment and ongoing safety and soundness of the FCS. Monitoring Systemwide trends helps FCA identify when risks are impacting the System's agricultural loans. For example, the System may show an overall increase in delinquent loans. Access to loan data allows the agency to analyze this trend and associated characteristics, such as geographic location, commodity linkage, or other commonalities among affected institutions. Similarly, the agency uses loan data to analyze the impact of emerging vulnerabilities, such as food safety concerns, trade disputes, changes in government support programs, shifts in consumer preferences, and climactic events. Using

loan data, the agency can better identify vulnerable System loans. Access to loan data increases FCA's understanding of the systemic risks facing the FCS and helps the agency determine if any policy actions are needed.

E. Developing Regulations and Policy

FCA uses loan data to support its regulation of System institutions. For example, loan data provide information needed to evaluate the impact of capital adequacy standards, lending limits, and liquidity requirements. Moreover, access to loan data allows the agency to analyze the effectiveness and results achieved from regulations and policy actions.

F. Fulfilling Reporting Requirements and Responding to Information Requests

The agency is required to periodically provide reports to Congress. The agency also frequently responds to information requests from Congress and others. Ready access to loan data aids FCA in timely and accurately responding to reporting requirements and information requests.

G. Why is FCA Considering ChangingLARS-M its Standardized Collection of Loan Data?

LARS-M was first implemented in 1987 and last revised in 1993. While LARS-M provides FCA with a standardized and centralized collection of loan data, it has not kept pace with changes in financial reporting systems, is incomplete as to loan types, lacks detail, and only allows access to current quarter data. FCA, therefore, believes improvements are needed to fully meet the agency's current and future information needs.

FCA examiners also obtain loan information directly from System institutions on an ad hocas-needed basis for use in conducting examinations, but this information is not standardized or centralized. As a result, directly downloaded data are not useful or available for Systemwide analysis or reporting. More importantly, the downloaded data vary considerably by FCA field office since loan information systems vary across System institutions. Therefore, standardized and centralized collection of loan data would help overcome the variety in electronic loan information systems used by FCS institutions.

II. Objectives of This Project

The objectives of FCA's project to reengineer its standardized collection of loan data from System institutions are to:

1. Determine the appropriate set of loan data to collect on a systematic, centralized, and standardized basis that meets the agency's needs;

2. Streamline the collection process of loan data to enhance reliability, timeliness, and data accuracy;

3. Minimize the reporting burden on System institutions; and

4. Provide appropriate standardized reports to internal and, potentially, external parties.

The reengineering project will address the limitations of the current approach to a standardized collection of loan data. The agency is already considering the data elements it needs to collect on

individual loans, including what specific financial information, loan performance data, and other essential information about loan characteristics that are necessary for adequately evaluating portfolio and loan risks. Moreover, the project will also address the agency's need to collect information for all loans made by System institutions. Along with these considerations, the agency is evaluating the data elements needed to model loan performance characteristics through time, such as probability of default, loss severity, and exposures at default. In the future, modeling loan performance may become a key aspect in the evaluation of a System institution's capital adequacy. FCA is also evaluating new technologies to streamline and improve the collection process. This evaluation includes reducing the reporting burden by relying on an efficient process that utilizes information readily available in the different FCS institutions' electronic loan information systems.

FCA is also evaluating the standardized reports the agency currently uses in conducting its supervisory and regulatory programs, including considering the type of reports to make available to the general public and System institutions in light of legal restrictions and other constraints regarding the release of private and sensitive business information used solely for examination purposes.

III. Questions

To augment the agency's experience and expertise with agricultural lending practices and credit analysis, FCA is seeking public input on the changes it should consider making as it reengineers the systematic collection of standardized loan data from System institutions. Specifically, the agency requests comments on:

1. What suggestions do you have regarding loan data elements?

2. What processes and technological approaches to employ to streamline the collection of loan data?

3. How to minimize the reporting burden on System institutions while meeting the agency's informational needs?

4. What standardized reports to make available to the general public and System institutions, considering the need to protect private and proprietary confidential information?

Along with these questions, we welcome any other comments or suggestions the agency should consider as it moves forward with this initiative.

Date: March 12, 2004

Jeanette C. Brinkley,
Secretary,
Farm Credit Administration Board.