Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FARM CREDIT ADMINISTRATION

12 CFR Parts 611, 615, 620 and 627

RIN 3052–AB58

Organization; Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Disclosure to Shareholders; Title V Conservators and Receivers; Capital Provisions

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA or Agency), through the FCA Board (Board), issues a proposed rule to amend its capital adequacy and related regulations to address interest rate risk as it pertains to Farm Credit System (System) institutions, the definition of insolvency for the purpose of appointing a receiver, the establishment of capital and bylaw requirements for System service corporations, and changes to risk-weighting categories. In addition, the proposed regulations address the retirement of other allocated equities included in core surplus, deferred-tax assets, the treatment of intra-System investments for capital computation purposes, various other computational issues, and other technical issues. The rule is intended to add safety and soundness requirements deferred from prior rulemakings, provide more consistency with capital requirements of other financial regulators, and make technical corrections.

DATES: Written comments should be received on or before November 24, 1997.

ADDRESSES: Comments may be mailed or delivered to Patricia W. DiMuzio, Director, Regulation Development Division, Office of Policy Development and Risk Control, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102–5090 or sent by facsimile transmission to (703) 734–5784. Comments may also be submitted via electronic mail to ''reg-comm@fca.gov.'' Copies of all communications received will be available for review by interested parties in the Office of Policy Development and Risk Control, Farm Credit Administration.

FOR FURTHER INFORMATION CONTACT:
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SUPPLEMENTARY INFORMATION:

I. General

Capital adequacy and customer eligibility regulations, adopted in January and effective in March 1997, added surplus and net collateral ratios for System institutions and established procedures for setting individual institution capital ratios and issuing capital directives. *See* 62 FR 4429, January 30, 1997. The purpose of these proposed regulations is to build on previous regulatory efforts by addressing discrete issues related to capital that were deferred during the FCA's consideration of its newly effective capital adequacy regulations. The issues in this proposed rulemaking include: (1) Interest rate risk; (2) the definition of insolvency for the purpose of appointing a conservator or receiver; (3) the establishment of capital and bylaw requirements for service corporations; and (4) various computational issues, and other issues involving the capital regulations. The objectives of these proposed amendments are:

1. To add provisions where the FCA believes significant capital issues have not been previously addressed in the regulations. Expressly addressing such issues in the regulations accords more certainty to both the Agency and System institutions regarding supervisory expectations and standards for enforcement.

2. To achieve consistency with the capital requirements of other Federal banking regulatory agencies (the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision) in areas of similar risk, such as risk-weighting of assets. In proposing changes, the FCA is cognizant that circumstances unique or special to System institutions may appropriately be addressed in a manner that differs from the treatment of commercial banks and thrifts by the other Federal banking regulators.

3. To make revisions and clarifications in the regulations that address concerns raised by FCA examiners and System institutions.

4. To make technical corrections including removing some inconsistencies in the computations of the core surplus and total surplus ratios.

II. Interest Rate Risk

For the past several years, the FCA has studied the feasibility of modifying the capital adequacy regulations to include a specific interest rate risk exposure component. The current regulations take a risk-based approach that addresses credit risk exposures but does not specifically address other potential exposures. Of particular concern to the FCA is the potentially adverse effect interest rate risk may have on net interest income and the market value of an institution's equity. Specifically, it is the risk of loss of net interest income or the market value of on- and off-balance sheet positions caused by a change in market interest rates. Similar actions to address interest rate risk have been undertaken by the other Federal banking agencies, which were required by section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) (Pub. L. 102–242, 105 Stat. 2236, 2354 (12 U.S.C. 1828 note)) to revise their risk-based capital guidelines to take adequate account of interest rate risk.

The FCA suspended development of the interest rate risk component until completion of higher priority capital adequacy regulations. The FCA is now proposing to add new §§ 615.5180 and 615.5181 to require banks to establish an interest rate risk management program and to provide that the banks' boards of directors and senior management are responsible for maintaining effective oversight. In addition, proposed § 615.5182 would require any other System institution (excluding the Federal Agricultural

Mortgage Corporation [1]) with significant interest rate risk to establish a risk management program.

The proposed rule reflects the FCA's belief that an institution's board and senior management are responsible for ensuring that risks are adequately identified, measured, monitored and controlled. Additionally, proposed §§ 615.5350(b)(7) and 615.5355(a)(4) provide that the FCA may take action against an institution for failure to maintain sufficient capital for interest rate risk exposures. Institutions found to have high levels of exposure or weak management practices may be directed by the FCA to take corrective action, including raising additional capital, strengthening management expertise, improving management information and measurement systems, reducing levels of exposure, or a combination thereof.

The requirements of the proposed rule are similar to interest rate risk management requirements in § 615.5135 of the investment regulations. The existing regulation provides more specific criteria regarding the interest rate risk management process. The proposed rule is general in nature and sets forth the FCA's expectations regarding board and management oversight, particularly maintaining adequate capital for interest rate risk exposures. As a result, the proposed rule provides a flexible regulatory approach to interest rate risk that encourages innovations in risk management practices while ensuring that the FCA can respond to emerging risks in an increasingly complex financial marketplace.

The FCA intends to provide additional guidance on specific criteria and guidelines in the form of a Board Policy Statement or Bookletter in the future. The guidelines will establish a risk assessment approach for the evaluation of capital adequacy specifically addressing interest rate risk, similar to the approach taken by the other Federal banking agencies, and would set forth the FCA's expectations for certain aspects of the institution's ongoing internal control process. These guidelines will address fundamental management practices for identifying, managing, controlling, monitoring, and reporting interest rate risk exposures. The guidelines will reflect the FCA's belief that all institutions should establish a risk management program appropriate for the level of an institution's overall interest rate risk exposure and complexity of its holdings and activities.

[1] Regulations affecting the Federal Agricultural Mortgage Corporation will be issued separately.

III. Definition of Insolvency

The FCA proposes several changes to § 627.2710, which sets forth the grounds for appointing a conservator or receiver for a System institution. First, the FCA proposes to amend the definition of ''insolvency'' as a ground for appointing a conservator or receiver in paragraph (b)(1) to clarify that any stock or allocated equities held by current or former borrowers are not ''obligations to members.'' The FCA believes that this approach for determining insolvency is consistent with financial statements based on generally accepted accounting principles (GAAP) [2] and more appropriately reflects the at-risk character of borrower stock and allocated equities. There would be no change in the treatment of obligations to members such as investment bonds and uninsured accounts. Second, the FCA would revise paragraph (b)(3), which currently provides that a conservator or receiver may be appointed if ''[t]he institution is in an unsafe or unsound condition to transact business.'' The revision would add that ''having insufficient capital or otherwise'' is a circumstance that the FCA could consider to be an unsafe or unsound condition. The proposed addition also identifies capital and collateral benchmarks below which an institution could be considered to be operating unsafely, as well as other conditions. The benchmarks and conditions are:

1. For banks, a net collateral ratio (as defined by § 615.5301(d)) of 102 percent.
2. For associations, collateral insufficient to meet the requirements of the association's general financing agreement with its affiliated bank.
3. For all institutions, permanent capital (as defined in § 615.5201) of less than one-half the minimum required level for the institution.
4. For all institutions, a relevant total surplus ratio (as defined by § 615.5301(i)) of less than 2 percent.
5. For associations, stock impairment.

The first two benchmarks address situations where an institution's continued liquidity is in doubt. In setting the proposed net collateral ratio benchmark at 102 percent, the FCA reviewed the requirements of the System's Market Access Agreement (MAA), as well as the collateral positions of the banks. The FCA also considered a 101-percent standard because the MAA has a 101-percent eligible collateral benchmark below which a bank's market access is restricted.[3] After deliberations, the FCA decided to propose a higher 102-percent benchmark to allow time to appoint a conservator or receiver before a bank is effectively unable to maintain normal funding activities. The Agency requests comment on the appropriateness of the 102-percent benchmark.

The third and fourth benchmarks identify situations where an institution is substantially undercapitalized. The last condition addresses a situation where an association could be exposed to significant customer and marketing uncertainties that may have a significant impact on financial viability or may affect other System institutions.

These benchmarks and conditions are intended to be examples of what the FCA would consider to be an unsafe or unsound condition to transact business but are not exclusive. The Agency would continue to have the discretion to deem an institution to be in an unsafe or unsound condition to transact business based on other activities or circumstances that are not enumerated in the regulation. The FCA notes that, under this proposal, it also retains the discretion not to appoint a conservator or receiver in the event that any of the enumerated circumstances exist. The Agency would evaluate the totality of circumstances before deciding what action, if any, to take.

In developing the proposed revision to this ground for appointing a conservator or receiver, the FCA reviewed the prompt corrective action benchmarks and tripwires used by the other Federal banking regulators with respect to commercial banks and thrifts. The other agencies' prompt corrective action regulations implement provisions of the FDICIA requiring such agencies to take certain supervisory actions, including the appointment of a conservator or receiver, well before insolvency is reached, if an institution's capital declines to unacceptable levels. Although the FCA is not subject to the FDICIA and continues to have supervisory discretion when System institutions are in troubled circumstances, the FCA supports the underlying philosophy of the FDICIA to take supervisory action before an institution is insolvent. It has been the experience of the FCA and the other Federal banking regulators that the longer a failing institution is allowed to remain open, the more difficult it will

[2] GAAP does not define insolvency. However, for the purposes of this regulation, insolvency means total liabilities greater than total assets based upon GAAP financial statements.

[3] The regulation's net collateral ratio is calculated net of any association investments counted as permanent capital by associations and determined using total liabilities, whereas eligible collateral is determined by dividing available collateral by obligations requiring collateralization.

ultimately be to resolve the affairs of the institution. Early intervention is even more important in the Farm Credit System where joint and several liability exists and where the financial health of one institution can affect the public image of other System institutions. The FCA notes that, for this reason, it is very likely that the Agency would appoint a conservator or receiver well before GAAP-based insolvency is reached.

IV. Service Corporations

A. Capital Requirements for Service Corporations

Section 4.25 of the Farm Credit Act of 1971, as amended (Act), requires System institutions to submit proposals to form service corporations to the FCA for issuance of a charter. Current regulations require the submission of bylaws and proposed amounts and sources of capitalization pursuant to § 611.1135(b)(3)(vii), (4), and (5). However, current regulations do not set standard capital requirements for all service corporations. The FCA proposes to amend § 611.1135(c) to address the establishment of capital requirements for service corporations.

Service corporations vary widely in their purpose and structure and present different types of risks to their parent banks or associations. The capital requirements for banks and associations would have little relevance for most service corporations because most service corporations have a small asset base and entirely different risks. Nor does the FCA believe that any single minimum capital adequacy standard is appropriate for all service corporations. The FCA instead proposes to set minimum capital adequacy requirements in the corporate charter approval process as a condition of approval. The FCA would monitor compliance through the examination process.

B. Application of Bylaw Regulations to Service Corporations

The capitalization bylaw provisions in § 615.5220 currently do not apply to service corporations, including the Farm Credit Services Leasing Corporation (FCL or Leasing Corporation). The FCA believes that all institutions, including service corporations, should have capital bylaws that meet the relevant requirements of that provision. The FCA, therefore, proposes to amend § 615.5220 by adding a new paragraph (b) requiring all service corporations to have relevant capitalization provisions in their bylaws. A conforming amendment to § 611.1135(b)(4) is also proposed.

V. Deferred-Tax Assets

A. The Proposed Rule

The FCA proposes to amend § 615.5201 to add new paragraph (d) to define deferred-tax assets that are dependent on future income or future events. The FCA also proposes to amend § 615.5210 to add a new paragraph (e)(11) establishing a requirement to exclude certain deferred-tax assets in capital calculations. Under the proposed rule, deferred-tax assets that can be realized through carrybacks to taxes paid on income earned in prior periods will not be excluded for regulatory capital purposes. However, deferred-tax assets that can be realized only if an institution earns sufficient taxable income in the future or that are dependent on the occurrence of other future events for realization will be partly excluded for regulatory capital purposes. The proposed exclusion is the amount in excess of the amount that the institution is expected to realize within 1 year of the most recent calendar quarter-end date, based on the institution's financial projections of taxable income and other events for that year, or the amount in excess of 10 percent of core surplus capital existing before the deduction of any disallowed tax assets, whichever is greater. Excluded deferred-tax assets will be deducted from capital and from assets for purposes of calculating capital ratios. This proposed exclusion is consistent with requirements of the other Federal banking agencies in response to the issuance by the Financial Accounting Standards Board (FASB) of the Statement of Financial Accounting Standards (SFAS) No. 109, ''Accounting for Income Taxes,'' in February 1992.

B. Discussion

Deferred-tax assets are assets that reflect, for financial reporting purposes, amounts that will be realized as reductions of future taxes or as refunds from a taxing authority. Deferred-tax assets may arise because of limitations under tax laws that provide that certain net operating losses or tax credits be carried forward if they cannot be used to recover taxes previously paid. These ''tax carryforwards'' are realized only if the institution generates sufficient future taxable income during the carryforward period.

Deferred-tax assets may also arise from deductible temporary differences in the tax and financial reporting of certain events. For example, institutions may report higher income to taxing authorities than they reflect in their financial records because their loan loss provisions are expensed for reporting purposes but are not deducted for tax purposes until the loans are charged off.

Deferred-tax assets arising from deductible temporary differences may be ''carried back'' and recovered from taxes previously paid. However, when deferred-tax assets arising from deductible temporary differences exceed such previously paid tax amounts, they will be realized only if there is sufficient future taxable income during the carryforward period.

Another type of deferred-tax assets arises from deductible temporary differences that are dependent on the occurrence of other future events.[4] These deferred-tax assets are not generally available for ''carried back or carry forward'' treatment, but rather are realized in the year the event occurs.

As with the other Federal banking agencies, the FCA has certain concerns about including in capital deferred-tax assets that are dependent upon future taxable income. Realization of such assets depends on whether a System institution that is subject to income tax has sufficient future taxable income during the carryforward period. Since an institution that is in a net operating loss carryforward position is often experiencing financial difficulties, its prospects for generating sufficient taxable income in the future are uncertain. In addition, the future prospects for a financial services organization can change rapidly. This raises concerns about the realization of deferred-tax assets that are dependent upon future taxable income, even when an institution appears to be sound and well managed. Thus, there is considerable uncertainty in determining whether deferred-tax assets will be realized. Many institutions are able to make reasonably accurate projections of future taxable income for relatively short periods of time, but beyond these short time periods, the reliability of the projections tends to decrease significantly.

Certain deferred-tax assets are realized upon the occurrence of certain future events other than taxable income. The same supervisory concerns exist regarding these tax assets as regarding tax assets dependent on future income. Several System institutions have significant amounts of deferred-tax assets that represent the expected refund of income taxes previously paid on earnings distributed in the form of nonqualified allocations of patronage to

[4] The regulations of the other Federal banking agencies do not address this type of deferred-tax assets because it is not applicable to the operations of commercial banks or thrifts, but SFAS No. 109 does encompass all types of such assets.

their stockholders. The realization of these deferred-tax assets is dependent not on future taxable income but rather on actions of the institutions to retire stock or allocated surplus associated with the nonqualified distributions. However, an institution might be unable to retire this stock and allocated equities during periods of financial difficulties when conversion of these deferred-tax assets to cash would be needed.

In addition, as it becomes less likely that deferred-tax assets will be realized, an institution is required under SFAS 109 to reduce its deferred-tax assets through increases to the asset's valuation allowance. Additions to this allowance would reduce an institution's regulatory capital at precisely the time it likely needs additional capital support.

C. Determination of the Deferred-Tax Exclusion

The FCA proposes to require the exclusion of the greater of the amount of deferred-tax assets dependent on future income or events that are not expected to be realized within 1 year, or the amount by which the deferred-tax assets exceed 10 percent of core surplus capital before the exclusion. To determine the deferred-tax exclusion, an institution would assume that all temporary differences fully reverse as of the calculation date. The amount of deferred-tax assets that are dependent upon future taxable income that is expected to be realized within 1 year means the amount of such deferred-tax assets that could be absorbed by the amount of income taxes that are expected to be payable based upon the institution's projected future taxable income for the next 12 months. Estimates of taxable income for the next year should include the effect of tax-planning strategies that the institution intends to implement to realize tax carryforwards that will otherwise expire during the year. Consistent with the other banking agencies and SFAS No. 109, the FCA believes that tax planning strategies are often carried out to prevent the expiration of such carryforwards. Deferred taxes that are dependent on other future events (other than future taxable income) and that are not expected to be realized within 1 year are to be deducted in the determination of the institution's capital measurements.

The FCA believes that institutions will not have significant difficulty in implementing these proposed limits. System institutions routinely make financial projections as part of their annual business planning process. Both the 1-year and 10-percent computations are straightforward and relatively simple. The Agency also believes that most System institutions would not be negatively affected by the implementation of this exclusion of deferred-tax assets. A small number of institutions that have significant tax-deferred assets may be initially unable to satisfy the core surplus ratio but should be able to comply within a relatively short time frame.

The proposed partial exclusion is intended to balance the continued concerns of the Agency about deferred-tax assets that are dependent upon future taxable income and other future events against the fact that such assets will, in many cases, be realized. The exclusion based on 10 percent of core surplus also would ensure that System institutions could not place excessive reliance on deferred-tax assets to satisfy the minimum capital standards.

D. Additional Guidance

The following additional guidance is provided to assist System institutions' understanding of how the FCA proposes to implement the deferred-tax exclusion.

1. Projecting Future Taxable Income and Other Events

Institutions may use the financial projections for planning the current fiscal year (adjusted for any significant changes that have occurred or are expected to occur) when applying the exclusion at an interim date within each fiscal year. In addition, while the proposed rule does not specify how originating temporary differences should be treated for purposes of projecting taxable income and other events for the next year, each institution should decide whether to adjust its financial projections for originating temporary differences and should follow a reasonable and consistent approach.

2. Tax Jurisdictions

Under this proposed rule, an institution would not be required to determine its exclusion of deferred-tax assets on a jurisdiction-by-jurisdiction basis. While an approach that looks at each jurisdiction separately may be more accurate from a theoretical standpoint, the FCA is in agreement with the other Federal banking agencies that the greater precision achieved by mandating such an approach would not outweigh the complexities involved and the inherent cost to institutions. Therefore, to limit regulatory burden, an institution would have the option to calculate one overall exclusion of deferred-tax assets that covers all tax jurisdictions in which it operates.

3. Available-for-Sale Securities

Under SFAS No. 115, ''Accounting for Certain Investments in Debt and Equity Securities'' (SFAS No. 115), available-for-sale securities are reported at fair value, with unrealized holding gains and losses on such securities, net of tax effects, included in a separate component of stockholders' equity. The Agency's current regulations exclude from regulatory capital the amount of net unrealized holding gains and losses on available-for-sale securities. It would be consistent to exclude the deferred tax effects relating to unrealized holding gains and losses on these available-for-sale securities from the calculation of the allowable amount of deferred-tax assets for regulatory capital purposes. However, requiring the exclusion of such deferred tax effects may add significant complexity to the regulatory capital standards and in most cases would not have a significant impact on regulatory capital ratios.

The FCA proposes to permit, but not require, institutions to adjust the amount of deferred-tax assets and liabilities arising from marking-to-market available-for-sale debt securities. This choice should reduce the implementation burden for institutions not wanting to contend with the complexity arising from such adjustments, while permitting those institutions that want to achieve greater precision to make such adjustments. However, institutions must follow a consistent approach with respect to such adjustments.

VI. Computational Issues

Following the implementation of the new capital adequacy provisions, various System institution representatives and FCA examiners have identified certain capital computational concerns and interpretive issues. Such issues primarily involved the computation of the total surplus and core surplus capital requirements. These issues are addressed below as technical corrections to the existing capital adequacy regulations.

A. Average Daily Balance Requirement

The FCA has received comments from System institutions voicing concern with the requirement to calculate the total and core surplus ratios using month-end balances. Institutions have commented that using month-end balances results in significant variability in the ratios due simply to seasonal lending trends. They recommended that the total and core surplus ratios be calculated using the same basis as permanent capital. The permanent capital ratio is computed using average daily balances for the most recent 3-month period.

The FCA proposes to amend § 615.5330(c) to require computation of the total surplus, core surplus, and risk-adjusted asset base using average daily balances for the most recent 3 months in the same way they are used for the calculation of permanent capital. The FCA is proposing this change for the following reasons:

1. The change will smooth out seasonal fluctuations in month-end balances that may result in undue volatility of the total and core surplus ratios;

2. The requirement is not a burden on System institutions because they already have the information-processing capability to compute the 3-month average of daily balances for various balance sheet accounts;

3. The change achieves consistency in the calculation methodology with regulatory permanent capital requirements; and

4. The 3-month average daily balance methodology is less susceptible to adjustment by delaying or advancing the recognition of various business activities compared to the month-end balances methodology.

Existing § 615.5205 requires institutions to maintain at all times a permanent capital ratio of at least the minimum required level. The FCA proposes to amend § 615.5330(a) and (b) to extend this requirement to the total and core surplus ratios as well. In each case the ratios would be calculated as described above. This change would also ensure ongoing compliance with the requirements of § 615.5240(c), which allows an institution's board of directors to delegate borrower stock retirements to management under certain conditions, including the maintenance of capital ratios at or above the minimum requirements.

The FCA is not proposing to change the requirement in § 615.5335(b) to compute the net collateral ratio using month-end balances at a specific point in time. However, the FCA proposes that banks expressly be required to achieve and maintain at all times a net collateral ratio at or above the regulatory minimum. In addition, banks must have the capability to calculate the net collateral ratio at any time using the balances outstanding at the computation date. Having this capability is important to banks to support daily issuances of debt securities to meet their funding needs.

B. Treatment of Intra-System Investments and Other Adjustments

1. Reciprocal Investments

The FCA proposes to clarify § 615.5210(e)(1) of the capital adequacy regulations that addresses the treatment of reciprocal holdings between two System institutions. The current regulation has not consistently been interpreted by institutions to require that the cross-elimination of reciprocal holdings be made before making the other required adjustments relating to intra-System investments. The FCA intended that elimination of investments between two System institutions be applied on a net basis after adjusting for reciprocal holdings (*see* 53 FR 16956, May 12, 1988). As an example, if institution A has a $100 equity investment in institution B, and institution B has a $25 equity investment in institution A, the net investment after offsetting reciprocal holdings is $75 (*i.e.*, $100—$25). The regulatory offsetting requirement results in the elimination of $25 from the capital and assets of both institutions. This ''netting effect'' ensures that double-counted cross-capital investments made by System institutions are eliminated prior to other adjustments required by the capital regulations. In the example above, the remaining $75 net investment is then the amount used when applying the other intra-System investment-related provisions of the regulations to the computation of permanent capital, total surplus, and core surplus. The FCA believes this clarification is necessary to avoid possible misinterpretations that may result in incorrect deductions.

2. Computation of Total and Core Surplus

The FCA proposes to clarify the treatment of intra-System equity investments and other deductions for the computation of total and core surplus. For the calculation of total surplus, the FCA proposes to amend § 615.5301(i)(7) to more clearly require the same deductions made in the computation of permanent capital. When calculating total surplus, System institutions should eliminate intra-System investments and other deductions from total surplus in a manner consistent with the elimination of such investments when an institution calculates its permanent capital. These eliminations are necessary to ensure that the investing institution does not include certain intra-System investments when computing total surplus and makes similar deductions such as elimination of certain tax-deferred assets. The FCA views most intra-System investments as a commitment of capital between related entities. From a regulatory capital adequacy perspective, elimination of most intra-System investments by the investing institution appropriately reflects that the capital commitment is in the related issuing institution.[5]

The FCA also proposes to eliminate § 615.5330(a)(2) and (a)(3) because these paragraphs are no longer necessary. As previously discussed, the FCA is proposing to amend § 615.5301(i)(7) to require the same deductions to be made in computing total surplus as are required for the calculation of permanent capital. With this revision to § 615.5301(i)(7), the existing requirements of § 615.5330 (a)(2) and (a)(3) are redundant.

With respect to core surplus, some institutions have interpreted the existing regulation as not requiring the elimination of an investment in another System institution (except for associations' investments in their affiliated banks), as is required in the calculation of other regulatory capital measurements. The FCA believes that the elimination of most intra-System investments from core surplus is also appropriate. For this reason, the FCA is proposing to amend § 615.5301(b)(4) to require the elimination of most intra-System investments from the computation of the core surplus of both the investing and the issuing institutions. However, investments to capitalize loan participations would not be eliminated from the investing institution's core surplus. The FCA views investments between System institutions resulting from loan participations as a pass-through of member-purchased or allocated equity. Because the issuing institution does not count such equities as core surplus, the FCA believes that elimination of such pass-through investments from the investing institution's core surplus would be unnecessary. The FCA invites comment on this approach and the alternative approach of eliminating intra-System investments relating to loan participations from the core surplus of the investing institution.

For the core surplus computation, existing § 615.5301(b)(3) requires institutions to make the deductions set forth in § 615.5210(e)(6) and (e)(7) for investments in the Leasing Corporation and for goodwill. The Agency intended for other relevant adjustments required for permanent capital to be made in the

[5] Only the issuing institution may include such equities in its total surplus, and only to the extent such equities qualify pursuant to § 615.5301(i).

core surplus ratio as well. Therefore, the FCA proposes to amend the core surplus computation also to require adjustments for loss-sharing agreements and for deferred-tax assets.

3. Investments in Service Corporations

Existing § 615.5210(e)(6) requires an institution to deduct its investment in the FCL from total capital for purposes of computing its permanent capital. The FCA proposes to require institutions to deduct their investments in all other service corporations as well. This change would be in conformity with the FCA's view that the capital is committed to support risks at the service corporation level and would clarify that such capital would be available to meet any capital requirements imposed by the Agency on service corporations. The required deductions would also be made in the investing institution's core and total surplus computations.

C. Counting Farm Credit System Financial Assistance Corporation (FAC) Obligations as a Liability on an Institution's Balance Sheet

Section 615.5210(a) of the existing regulations provides that no FAC obligations shall be included in the balance sheets of any Farm Credit institution. The FCA proposes to restrict this treatment to only those FAC obligations that were issued to pay capital preservation and loss-sharing agreements.

System institutions are obligated under the Act to: (1) Repay Treasury-paid interest from direct assistance and general Systemwide FAC debt; (2) pay interest on direct assistance FAC obligations; and (3) pay principal and interest on capital preservation-related FAC debt. Section 6.9(e)(3)(E) of the Act provides that certain obligations of the FAC issued in connection with the capital preservation and loss-sharing agreements not be included in the obligations of any institution for reporting purposes. In 1988, when the FCA determined that this exception to GAAP should also be included in the capital regulations, it made the exception broader than the statute by applying it to all FAC obligations. Since the relevant provision of the Act refers only to the obligations of the FAC that were issued in connection with the repayment of capital preservation agreements, the FCA proposes to conform the language of the regulation to the statute.

D. Changes in Risk-Weighting Categories and Credit Conversion Factors for Calculating Risk-Adjusted Assets

The FCA proposes modifications to the risk-weighting categories for on-and off-balance-sheet assets in § 615.5210(f). The purposes of the modifications are to provide a more accurate weighting of assets relative to their risk and to incorporate recent changes to the Basle Accord,[6] as well as to provide consistency with the requirements of the other Federal banking agencies. The following changes are proposed:

1. Elimination of the 10-Percent Category

The FCA proposes to eliminate this risk-weight category as set forth in existing § 615.5210(f)(2)(ii). The assets in this category would be reassigned to other categories that more accurately reflect their credit risks, consistent with the risk-weighting treatment by the other Federal banking agencies. Securities issued by the U.S. Government or its agencies and portions of loans and other assets guaranteed by the full faith and credit of the U.S. Government or its agencies would be risk-weighted at 0 percent in § 615.5210(f)(2)(i). Cash items in the process of collection and portions of loans and other assets collateralized by securities of the U.S. Government or its agencies would be risk-weighted at 20 percent in new § 615.5210(f)(2)(ii). These changes would make the FCA's risk-weighting of these items consistent with that of the other financial regulators.

2. Risk-Weighting of Assets That Are Conditionally Guaranteed by the U.S. Government or Its Agencies at 20 Percent

Such assets are not specifically distinguished from unconditional guarantees in the FCA's current weighting scheme. However, the FCA is now proposing to differentiate between unconditional guarantees, which have a risk-weighting of 0 percent, and conditional guarantees, which are proposed to be risk-weighted at 20 percent, in new § 615.5210(f)(2)(ii)(B). Government-sponsored agency securities not backed by the full faith and credit of the U.S. Government would also be risk-weighted at 20 percent. In developing the proposed revisions, the FCA believes that such guarantees pose some risk and that 20 percent is the appropriate risk-weighting for the general credit risk and would conform to the treatment of such assets by the other financial regulators.

3. Modification of the Definitions of Two Items Involving Foreign Banks

Claims on foreign banks with an original maturity of 1 year or less are now risk-weighted at 20 percent, and those with an original maturity of more than 1 year are weighted at 100 percent. For risk-weighting purposes, the FCA proposes to make a distinction between the Organization for Economic Cooperation and Development (OECD)-based group of countries[7] and non-OECD-based countries in the same fashion as the other Federal banking agencies. Generally, membership in the OECD indicates that such member countries have lower levels of sovereign risk and, therefore, justifies a lower risk-weighting. The FCA proposes to risk-weight all claims on OECD banks at 20 percent in new § 615.5210(f)(2)(ii), regardless of maturity, and claims on non-OECD banks at 20 percent when the remaining maturity is 1 year or less. Claims on non-OECD banks with a remaining maturity of more than 1 year would be risk-weighted at 100 percent in new § 615.5210(f)(2)(iv). The FCA has added a definition of OECD in § 615.5201(j).

4. Risk-Weighting of Unused Commitments With an Original Maturity of Less Than 14 Months at 0 Percent

Unused commitments with an original maturity of more than 1 year now have a 50-percent credit conversion factor, which means that 50 percent of the face amount of such commitments must be added to the appropriate risk-weighting category, usually 100 percent. Many loans made by Farm Credit institutions are on annual renewal cycles. It is the established practice of

[6] Agreed to by the Committee on Banking Regulations and Supervisory Practices, under the auspices of the Bank for International Settlements in Basle, Switzerland (Basle Committee). Under this agreement the other Federal banking agencies that are signatories to the Accord are bound to consider such direction and revise their regulations accordingly. The FCA, for consistency purposes, also chooses to consider and revise its regulations, as appropriate to the System.

[7] OECD means countries that are full members of the Organization for Economic Cooperation and Development. As of August 1997, the OECD includes the following countries: Australia, Austria, Belgium, Canada, the Czech Replublic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, South Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Saudia Arabia has concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow which, together with the aforementioned countries that are full members of the OECD, comprise the OECD-based group of countries.

many of these institutions that, in order to have loan commitments in place at the beginning of each annual cycle, the credit review and subsequent commitment are typically done 30 to 60 days prior to the end of the current loan commitment. Consequently, such ''advance'' commitments have been classified in the 50-percent credit conversion category. The FCA has concluded that these annual advance commitments do not differ substantially from commitments made with an original maturity of 1 year or less.

The FCA proposes in § 615.5210(f)(3)(ii) to classify in the 0-percent credit conversion category those binding commitments with an original maturity of 14 months or less. This change is intended to recognize that the timing of the issuance of binding commitments is appropriately related to the annual operating cycle of borrowers, so that institutions can continue current practices and be able to risk-weight such loans at 0 percent.

5. Revision of Credit Conversion Factors for Derivative Transactions

In September 1995, the other Federal banking agencies adopted final amendments to their risk-based capital regulations relating to derivative transactions based on the Basle Committee's recommendations. *See* 60 FR 46171, September 5, 1995.[8] Their final rule amended the matrix of conversion factors used to calculate potential future exposure and permitted institutions to recognize the effects of qualifying bilateral netting arrangements in the calculation of potential future exposure. The matrix of conversion factors used to calculate potential future exposure was expanded to take into account innovations in the derivatives markets. Specifically, the matrix was modified by adding higher conversion factors to address long-dated transactions (*e.g.*, contracts with remaining maturities over 5 years), and new conversion factors were added to cover certain types of derivative transactions not previously covered.

In conformity with the other Federal banking agencies, the FCA proposes to amend § 615.5210(f)(3)(iii) to permit institutions to net positive and negative mark-to-market values of derivatives contracts entered into with a single counterparty subject to a qualifying, legally enforceable bilateral netting arrangement for purposes of determining credit equivalent amounts. The FCA is adding a definition of ''qualifying bilateral netting contract'' in new § 615.5201(m). The FCA also proposes to adopt the formula used by the other Federal banking agencies for current and potential future exposure for contracts subject to qualifying bilateral netting agreements. The formula is expressed as $A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$ where:

a. A_{net} is the adjusted potential future credit exposure;

b. A_{gross} is the sum of potential future credit exposures determined by multiplying the notional principal amount by the appropriate credit conversion factor; and

c. NGR is the ratio of the net current credit exposure divided by the gross current credit exposure determined as the sum of only the positive mark-to-markets for each derivative contract with the single counterparty.

In addition, the FCA proposes to amend the conversion factor matrix as set forth in the following table:

CONVERSION FACTOR MATRIX
[In percent]

Remaining maturity	Interest rate	Exchange rate	Commodity
1 year or less	0.0	1.0	10.0
Over 1 to 5 years	0.5	5.0	12.0
Over 5 years	1.5	7.5	15.0

The FCA would further require that, for any derivative contracts that do not fall into one of the categories above, the potential future credit exposure must be determined using the commodity conversion factors.

VII. Other Issues

A. Retirement of Other Allocated Equities Included in Core Surplus

The FCA's recently adopted capital adequacy regulations permit associations to include, subject to limitations, both nonqualified and qualified allocated equities in core surplus. The regulations permit the inclusion of nonqualified allocated equities that are not distributed according to an established plan or practice. The regulations further allow associations to include in core surplus other allocated equities (*i.e.*, qualified or nonqualified notices of allocation) with an original maturity of at least 5 years and not scheduled for revolvement during the next 3 years. The preamble to the Capital Adequacy and Customer Eligibility final rule (62 FR 4429, January 30, 1997) discussed disallowing a series or class of allocated equities from treatment as core surplus in the event of partial retirements. The preamble also described exceptions to the disallowance requirement if an institution retires allocated equities in the event of loan default or the death of the equityholder. However, in the regulation the disallowance for partial retirements, as well as the exceptions, appeared to apply only to the nonqualified allocated equities without a plan or practice of revolvement.

Several System associations have asked the FCA whether the other allocated equities includible in core surplus would also be disallowed in the event of partial retirement. The remaining equities would be disallowed, and the related exceptions would apply in such circumstances. The FCA is now proposing to amend § 615.5310(b)(2)(ii) in order to ensure consistent treatment of all allocated equities counted as core surplus in the event of partial retirements.

[8] In July 1994 the Basle Accord was revised to permit institutions to net positive and negative mark-to-market values of rate contracts entered into with a single counterparty subject to a qualifying, legally enforceable, bilateral netting agreement. Based upon this revision to the Basle Accord, the other Federal banking agencies revised their risk-based capital regulations accordingly.

B. Ensuring Two Nominees for Each Bank Director's Position and Ensuring Representation on the Board of all Types of Agriculture in the District

Section 4.15 of the Act requires associations to ''endeavor to assure'' that, when directors are elected, there are at least two nominees for each position and that representation of all types of agriculture practiced in the territory is achieved to the extent possible. The statute goes on to say that ''[r]egulations of the Farm Credit Administration governing the election of bank directors shall similarly assure a choice of two nominees for each elective office to be filled and that the bank board represent as nearly as possible all types of agriculture in the district.'' The FCA interprets the provision to require banks to make a good faith effort to locate at least two nominees and to try to assure representation on the board that is reflective of the bank's territory. The Agency proposes to add a new paragraph (5) to § 615.5230(b) to require documentation of that effort. In the event that a bank is unable to find at least two nominees for each position, the bank would be required to keep written documentation of its efforts to do so. The bank would also be required to keep a record of the type of agriculture engaged in by each director on its board.

In addition, the FCA proposes to add § 611.350 to add a reference in the subpart on director elections to the cooperative principles set forth in § 615.5230 that apply to such elections.

C. Statement of SFAS No. 130, Reporting Comprehensive Income

The FASB recently issued SFAS No. 130, Reporting Comprehensive Income (Statement). This Statement sets forth standards for reporting and display of comprehensive income in a full set of financial statements. For fiscal years beginning after December 15, 1997, this Statement will require financial statements to display a balance representing the accumulation of other comprehensive income. This new balance will be displayed separately from retained earnings and additional paid-in capital in the equity (capital) section of the statement of financial position. For the most part, the FCA believes that the Statement represents only a change in display of existing financial transactions and, therefore, does not introduce any new issues that have an effect on the Agency's current regulatory capital standards. The FCA believes that current standards in the capital regulations already address the transactional items that comprise the newly separated component of equity. Accordingly, the FCA has determined that there are no compelling reasons to change the capital standards to take into account the changes in the display of financial transactions resulting from this Statement. The Agency invites any parties with an interest in this issue to submit comments.

E. Conforming Amendments

The FCA proposes to amend § 620.5 to require institutions to disclose information on their surplus and collateral ratios in the annual report to shareholders. Conforming, nonsubstantive changes are also proposed in § 615.5201(h) to replace ''allocation'' with ''allotment'' and in §§ 615.5210(b) and 615.5260(a)(3)(ii) to remove obsolete language.

List of Subjects

12 CFR Part 611

Agriculture, Banks, banking, Rural areas.

12 CFR Part 615

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

12 CFR Part 620

Accounting, Agriculture, Banks, banking, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 627

Agriculture, Banks, banking, Claims, Rural areas.

For the reasons stated in the preamble, parts 611, 615, 620, and 627 of chapter VI, title 12 of the Code of Federal Regulations are proposed to be amended to read as follows:

PART 611—ORGANIZATION

1. The authority citation for part 611 continues to read as follows:

Authority: Secs. 1.3, 1.13, 2.0, 2.10, 3.0, 3.21, 4.12, 4.15, 4.21, 5.9, 5.10, 5.17, 7.0—7.13, 8.5(e) of the Farm Credit Act (12 U.S.C. 2011, 2021, 2071, 2091, 2121, 2142, 2183, 2203, 2209, 2243, 2244, 2252, 2279a—2279f–1, 2279aa–5(e)); secs. 411 and 412 of Pub. L. 100–233, 101 Stat. 1568, 1638; secs. 409 and 414 of Pub. L. 100–399, 102 Stat. 989, 1003, and 1004.

Subpart C—Election of Directors

2. Section 611.350 is added to read as follows:

§ 611.350 Application of cooperative principles to the election of directors.

In the election of directors, each System institution shall comply with the applicable cooperative principles set forth in § 615.5230 of this chapter.

Subpart I—Service Organizations

3. Section 611.1135 is amended by revising paragraphs (b)(4) and (c) to read as follows:

§ 611.1135 Incorporation of service organizations.

* * * * *

(b) * * *

(4) The proposed bylaws, which shall include the provisions required by § 615.5220(b) of this chapter.

* * * * *

(c) *Approval.* The Farm Credit Administration may condition the issuance of a charter, including imposing minimum capital requirements, as it deems appropriate. For good cause, the Farm Credit Administration may deny the application. Upon approval by the Farm Credit Administration of a completed application, which shall be kept on file at the Farm Credit Administration, the Agency shall issue a charter for the service corporation which shall thereupon become a corporate body and a Federal instrumentality.

* * * * *

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

4. The authority citation for part 615 continues to read as follows:

Authority: 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.

Subpart E—Investment Management

5. Section 615.5135 is amended by revising the introductory paragraph to read as follows:

§ 615.5135 Management of interest rate risk.

The board of directors of each Farm Credit Bank, bank for cooperatives, and agricultural credit bank shall develop and implement an interest rate risk management program as set forth in subpart G of this part. The board of directors shall adopt an interest rate risk management section of an asset/liability management policy which establishes interest rate risk exposure limits as well as the criteria to determine compliance with these limits. At a minimum, the interest rate risk management section shall establish policies and procedures for the bank to:

* * * * *

6. A new subpart G is added to read as follows:

Subpart G—Risk Assessment and Management

Sec.

615.5180 Interest rate risk management by banks—general.

615.5181 Bank interest rate risk management program.

615.5182 Interest rate risk management by associations and other Farm Credit System institutions other than banks.

Subpart G—Risk Assessment and Management

§ 615.5180 Interest rate risk management by banks—general.

The board of directors of each Farm Credit Bank, bank for cooperatives, and agricultural credit bank shall develop and implement an interest rate risk management program tailored to the needs of the institution and consistent with the requirements set forth in § 615.5135 of this part. The program shall establish a risk management process that effectively identifies, measures, monitors, and controls interest rate risk.

§ 615.5181 Bank interest rate risk management program.

(a) The board of directors of each Farm Credit Bank, bank for cooperatives, and agricultural credit bank is responsible for providing effective oversight to the interest rate risk management program and must be knowledgeable of the nature and level of interest rate risk taken by the institution.

(b) Senior management is responsible for ensuring that interest rate risk is properly managed on both a long-range and a day-to-day basis.

§ 615.5182 Interest rate risk management by associations and other Farm Credit System institutions other than banks.

Associations and other Farm Credit System institutions other than banks, excluding the Federal Agricultural Mortgage Corporation, with interest rate risk that could lead to significant declines in net income or in the market value of capital shall comply with the requirements of §§ 615.5180 and 615.5181. The interest rate risk program shall be commensurate with the level of direct interest rate exposure under the management control of the institution.

Subpart H—Capital Adequacy

7. Section 615.5201 is amended by removing the word ''allocation'' and adding in its place, the word ''allotment'' in paragraph (h); redesignating paragraphs (d), (e), (f), (g), (h), (i), (j), (k), (l), (m), and (n) as paragraphs (e), (f), (g), (h), (i), (k), (l), (n), (o), (p), and (q) respectively; and adding new paragraphs (d), (j), and (m) to read as follows:

§ 615.5201 Definitions.

* * * * *

(d) *Deferred-tax assets that are dependent on future income or future events* means:

(1) Deferred-tax assets arising from deductible temporary differences dependent upon future income that exceed the amount of taxes previously paid that could be recovered through loss carrybacks if existing temporary differences (both deductible and taxable and regardless of where the related tax deferred effects are recorded on the institution's balance sheet) fully reverse;

(2) Deferred-tax assets dependent upon future income arising from operating loss and tax carryforwards; or

(3) Deferred-tax assets arising from temporary differences that could be recovered if existing temporary differences that are dependent upon other future events (both deductible and taxable and regardless of where the related tax deferred effects are recorded on the institution's balance sheet) fully reverse.

* * * * *

(j) *OECD* means the group of countries that are full members of the Organization for Economic Cooperation and Development, regardless of entry date, as well as countries that have concluded special lending arrangements with the International Monetary Fund's General Arrangement to Borrow, excluding any country that has rescheduled its external sovereign debt within the previous 5 years.

* * * * *

(m) *Qualifying bilateral netting contract* means a bilateral netting contract that meets at least the following conditions:

(1) The contract is in writing;

(2) The contract is not subject to a walkaway clause;

(3) The contract creates a single obligation either to pay or to receive the net amount of the sum of positive and negative mark-to-market values for all derivative contracts subject to the qualifying bilateral netting contract;

(4) The institution receives a legal opinion that represents, to a high degree of certainty, that in the event of legal challenge the relevant court and administrative authorities would find the institution's exposure to be the net amount;

(5) The institution establishes a procedure to monitor relevant law and to ensure that the contracts continue to satisfy the requirements of this section; and

(6) The institution maintains in its files adequate documentation to support the netting of a derivatives contract.

* * * * *

6. Section 615.5210 is amended by adding new paragraph (e)(11); removing paragraph (f)(2)(v); and revising paragraphs (a), (b), (e) introductory text, (e)(1), (e)(6), (f)(2)(i), (f)(2)(ii), heading of (f)(2)(iii), (f)(2)(iv), (f)(3) introductory text, (f)(3)(ii)(A), and (f)(3)(iii) to read as follows:

§ 615.5210 Computation of the permanent capital ratio.

(a) The institution's permanent capital ratio shall be determined on the basis of the financial statements of the institution prepared in accordance with generally accepted accounting principles except that the obligations of the Farm Credit System Financial Assistance Corporation issued to repay banks in connection with the capital preservation and loss-sharing agreements described in section 6.9(e)(1) of the Act shall not be considered obligations of any institution subject to this regulation prior to their maturity.

(b) The institution's asset base and permanent capital shall be computed using average daily balances for the most recent 3 months.

* * * * *

(e) For the purpose of computing the institution's permanent capital ratio, the following adjustments shall be made prior to assigning assets to risk-weight categories and computing the ratio:

(1) Where two Farm Credit System institutions have stock investments in each other, such reciprocal holdings shall be eliminated to the extent of the offset. If the investments are equal in amount, each institution shall deduct from its assets and its total capital an amount equal to the investment. If the investments are not equal in amount, each institution shall deduct from its total capital and its assets an amount equal to the smaller investment. The elimination of reciprocal holdings required by this paragraph shall be made prior to making the other adjustments required by this subsection.

* * * * *

(6) The double-counting of capital between a service corporation chartered

under section 4.25 of the Act and its owner institutions shall be eliminated by deducting an amount equal to their investment in the service corporation from their total capital.

* * * * *

(11) For purposes of calculating capital ratios under this part, deferred-tax assets are subject to the conditions, limitations, and restrictions described in this paragraph.

(i) Each institution shall deduct an amount of deferred-tax assets, net of any valuation allowance, from its assets and its total capital that is equal to the greater of:

(A) The amount of deferred-tax assets that are dependent on future income or future events in excess of the amount that is reasonably expected to be realized within 1 year of the most recent calendar quarter-end date, based on financial projections for that year, or

(B) The amount of deferred-tax assets that are dependent on future income or future events in excess of ten (10) percent of the amount of core surplus that exists before the deduction of any deferred-tax assets.

(ii) For purposes of this calculation:

(A) The amount of deferred-tax assets that can be realized from taxes paid in prior carryback years and from the reversal of existing taxable temporary differences shall not be deducted from assets and from equity capital.

(B) All existing temporary differences should be assumed to fully reverse at the calculation date.

(C) Projected future taxable income should not include net operating loss carryforwards to be used within 1 year or the amount of existing temporary differences expected to reverse within that year.

(D) Financial projections shall include the estimated effect of tax planning strategies that are expected to be implemented to minimize tax liabilities and realize tax benefits. Financial projections for the current fiscal year (adjusted for any significant changes that have occurred or are expected to occur) may be used when applying the capital limit at an interim date within the fiscal year.

(E) The deferred tax effects of any unrealized holding gains and losses on available-for-sale debt securities may be excluded from the determination of the amount of deferred-tax assets that are dependent upon future taxable income and the calculation of the maximum allowable amount of such assets. If these deferred-tax effects are excluded, this treatment must be followed consistently over time.

(f) * * *

(2) * * *

(i) *Category 1: 0 Percent.*

(A) Cash on hand and demand balances held in domestic or foreign banks.

(B) Claims on Federal Reserve Banks.

(C) Goodwill.

(D) Direct claims on and portions of claims unconditionally guaranteed by the United States Treasury, United States Government agencies, or central governments in other OECD countries. A United States Government agency is defined as an instrumentality of the United States Government whose obligations are fully and explicitly guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States Government.

(ii) *Category 2: 20 Percent.*

(A) Portions of loans and other assets collateralized by United States Government-sponsored agency securities. A United States Government-sponsored agency is defined as an agency originally chartered or established to serve public purposes specified by the United States Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the United States Government.

(B) Portions of loans and other assets conditionally guaranteed by the United States Government or its agencies.

(C) Portions of loans and other assets collateralized by securities issued or guaranteed (fully or partially) by the United States Government or its agencies (but only to the extent guaranteed).

(D) Claims on domestic banks (exclusive of demand balances).

(E) Claims on, or guarantees by, OECD banks.

(F) Claims on non-OECD banks with a remaining maturity of 1 year or less.

(G) Investments in State and local government obligations backed by the ''full faith and credit of State or local government.'' Other claims (including loans) and portions of claims guaranteed by the full faith and credit of a State government (but only to the extent guaranteed).

(H) Claims on official multinational lending institutions or regional development institutions in which the United States Government is a shareholder or contributor.

(I) Loans and other obligations of and investments in Farm Credit institutions.

(J) Local currency claims on foreign central governments to the extent that the Farm Credit institution has local liabilities in that country.

(K) Cash items in the process of collection.

(iii) *Category 3: 50 Percent.*

* * * * *

(iv) *Category 4: 100 Percent.*

(A) All other claims on private obligors.

(B) Claims on non-OECD banks with a remaining maturity greater than 1 year.

(C) All other assets not specified above, including but not limited to, leases, fixed assets, and receivables.

(D) All non-local currency claims on foreign central governments, as well as local currency claims on foreign central governments that are not included in Category 2(J).

* * * * *

(3) * * *

(i) * * *

(ii) Credit conversion factors shall be applied to off-balance-sheet items as follows:

(A) *0 Percent.*

(*1*) Unused commitments with an original maturity of 14 months or less; or

(*2*) Unused commitments with an original maturity of greater than 14 months if:

* * * * *

(iii) *Credit equivalents of interest rate contracts and foreign exchange contracts.*

(A) Credit equivalents of interest rate contracts and foreign exchange contracts (except single currency floating/floating interest rate swaps) shall be determined by adding the replacement cost (mark-to-market value, if positive) to the potential future credit exposure, determined by multiplying the notional principal amount by the following credit conversion factors as appropriate.

CONVERSION FACTOR MATRIX

[In Percent]

Remaining maturity	Interest rate	Exchange rate	Commodity
One year or less	0.0	1.0	10.0

CONVERSION FACTOR MATRIX—Continued
[In Percent]

Remaining maturity	Interest rate	Exchange rate	Commodity
Over 1 to 5 years	0.5	5.0	12.0
Over 5 years	1.5	7.5	15.0

(B) For any derivative contract that does not fall within one of the categories in the above table, the potential future credit exposure shall be calculated using the commodity conversion factors. The net current exposure for multiple derivative contracts with a single counterparty and subject to a qualifying bilateral netting contract shall be the net sum of all positive and negative mark-to-market values for each derivative contract. The positive sum of the net current exposure shall be added to the adjusted potential future credit exposure for the same multiple contracts with a single counterparty. The adjusted potential future credit exposure shall be computed as $A_{net}=(0.4 \times A_{gross})+0.6\ (NGR \times A_{gross})$ where:

(*1*) A_{net} is the adjusted potential future credit exposure;

(*2*) A_{gross} is the sum of potential future credit exposures determined by multiplying the notional principal amount by the appropriate credit conversion factor; and

(*3*) NGR is the ratio of the net current credit exposure divided by the gross current credit exposure determined as the sum of only the positive mark-to-markets for each derivative contract with the single counterparty.

* * * * *

Subpart I—Issuance of Equities

9. Section 615.5220 is amended by redesignating paragraphs (a) through (h) as new paragraphs (1) through (8) consecutively; by adding the paragraph designation ''(a)'' to the introductory text; and by adding a new paragraph (b) to read as follows:

§ 615.5220 Capitalization bylaws.

* * * * *

(b) The board of directors of each service corporation (including the Leasing Corporation) shall adopt capitalization bylaws, subject to the approval of its voting shareholders, that set forth the requirements of paragraphs (a)(1), (a)(2), and (a)(3) of this section to the extent applicable. Such bylaws shall also set forth the manner in which equities will be retired and the manner in which earnings will be distributed.

10. Section 615.5230 is amended by adding a new paragraph (b)(5) to read as follows:

§ 615.5230 Implementation of cooperative principles.

* * * * *

(b) * * *

(5) Each bank shall endeavor to assure that there is a choice of at least two nominees for each elective office to be filled and that the board represent as nearly as possible all types of agriculture in the district. If fewer than two nominees for each position are named, the efforts of the bank to locate two willing nominees shall be documented in the books and records of the bank. The bank shall also maintain a list of the type or types of agriculture engaged in by each director on its board.

Subpart J—Retirement of Equities

11. Section 615.5260 is amended by revising paragraph (a)(3)(ii) to read as follows:

§ 615.5260 Retirement of eligible borrower stock.

(a) * * *

(3) * * *

(ii) In the case of participation certificates and other equities, face or equivalent value; or

* * * * *

Subpart K—Surplus and Collateral Requirements

12. Section 615.5301 is amended by revising paragraphs (a), (b)(2)(ii), (b)(3), (b)(4), and (i)(7) to read as follows:

§ 615.5301 Definitions.

* * * * *

(a) The terms *deferred-tax assets that are dependent on future income or future events, institution, permanent capital,* and *total capital* shall have the meanings set forth in § 615.5201.

* * * * *

(b) * * *

(2) * * *

(ii) The allocated equities, if subject to revolvement, are not scheduled for revolvement during the next 3 years, provided that, in the event that such allocated equities included in core surplus are retired, other than as required by section 4.14B of the Act, or in connection with a loan default or the death of an equityholder whose loan has been repaid (to the extent provided for in the institution's capital adequacy plan), any remaining such allocated equities that were allocated in the same year will be excluded from core surplus.

(3) The deductions required to be made by an institution in the computation of its permanent capital pursuant to § 615.5210(e)(6), (7), (9), and (11) shall also be made in the computation of its core surplus. Deductions required by § 615.5210(e)(1) shall also be made to the extent that they do not duplicate deductions calculated pursuant to this section and required by § 615.5330(b)(2).

(4) Equities issued by System institutions and held by other System institutions shall not be included in the core surplus of the issuing institution or of the holder, unless approved pursuant to paragraph (b)(1)(iv) of this section, except that equities held in connection with a loan participation shall not be excluded by the holder. This paragraph shall not apply to investments by an association in its affiliated bank, which are governed by § 615.5301(b)(1)(i).

* * * * *

(i) * * *

(7) Any deductions made by an institution in the computation of its permanent capital pursuant to § 615.5210(e) shall also be made in the computation of its total surplus.

13. Section 615.5330 is revised to read as follows:

§ 615.5330 Minimum surplus ratios.

(a) *Total surplus.*

(1) Each institution shall achieve and at all times maintain a ratio of at least 7 percent of total surplus to the risk-adjusted asset base.

(2) The risk-adjusted asset base is the total dollar amount of the institution's assets adjusted in accordance with § 615.5301(i)(7) and weighted on the basis of risk in accordance with § 615.5210(f).

(b) *Core surplus.*

(1) Each institution shall achieve and at all times maintain a ratio of core surplus to the risk-adjusted asset base of at least 3.5 percent, of which no more than 2 percentage points may consist of

allocated equities otherwise includible pursuant to § 615.5301(b).

(2) Each association shall compute its core surplus ratio by deducting an amount equal to the net investment in the bank from its core surplus.

(3) The risk-adjusted asset base is the total dollar amount of the institution's assets adjusted in accordance with §§ 615.5301(b)(3) and 615.5330(b)(2), and weighted on the basis of risk in accordance with § 615.5210(f).

(c) An institution shall compute its risk-adjusted asset base, total surplus, and core surplus ratios using average daily balances for the most recent 3 months.

14. Section 615.5335 is revised to read as follows:

§ 615.5335 Bank net collateral ratio.

(a) Each bank shall achieve and at all times maintain a net collateral ratio of at least 103 percent.

(b) At a minimum, a bank shall compute its net collateral ratio as of the end of each month. A bank shall have the capability to compute its net collateral ratio a day after the close of a business day using the daily balances outstanding for assets and liabilities for that date.

Subpart L—Establishment of Minimum Capital Ratios for an Individual Institution

15. Section 615.5350 is amended by adding a new paragraph (b)(7) to read as follows:

§ 615.5350 General—Applicability.

* * * * *

(b) * * *

(7) An institution with significant exposures to declines in net income or in the market value of its capital due to a change in interest rates and/or the exercising of embedded or explicit options.

Subpart M—Issuance of a Capital Directive

16. Section 615.5355 is amended by revising paragraph (a)(4) to read as follows:

§ 615.5355 Purpose and scope.

(a) * * *

(4) Take other action, such as reduction of assets or the rate of growth of assets, restrictions on the payment of dividends or patronage, or restrictions on the retirement of stock, to achieve the applicable capital ratios, or reduce levels of interest rate and other risk exposures, or strengthen management expertise, or improve management information and measurement systems; or

* * * * *

PART 620—DISCLOSURE TO SHAREHOLDERS

17. The authority citation for part 620 continues to read as follows:

Authority: Secs. 5.17, 5.19, 8.11 of the Farm Credit Act (12 U.S.C. 2252, 2254, 2279aa–11); sec. 424 of Pub. L. 100–233, 101 Stat. 1568, 1656.

Subpart A—General

§ 620.1 [Amended]

18. Section 620.1 is amended by removing the reference ''§ 615.5201(j)'' and adding in its place, the reference ''§ 615.5201(l)'' in paragraph (j).

Subpart B—Annual Report to Shareholders

§ 620.5 [Amended]

19. Section 620.5 is amended by removing the word ''permanent'' from paragraphs (d)(2), (g)(4)(v), and (g)(4)(vi); by revising paragraph (f)(3); and by adding paragraph (f)(4) to read as follows:

§ 620.5 Contents of the annual report to shareholders.

* * * * * *

(f) * * *

(3) *For all banks* (on a bank-only basis):

(i) Permanent capital ratio.

(ii) Total surplus ratio.

(iii) Core surplus ratio.

(iv) Net collateral ratio.

(4) *For all associations*:

(i) Permanent capital ratio.

(ii) Total surplus ratio.

(iii) Core surplus ratio.

* * * * *

PART 627—TITLE V CONSERVATORS AND RECEIVERS

20. The authority citation for part 627 continues to read as follows:

Authority: Secs. 4.2, 5.9, 5.10, 5.17, 5.51, 5.58 of the Farm Credit Act (12 U.S.C. 2183, 2243, 2244, 2252, 2277a, 2277a–7).

Subpart A—General

21. Section 627.2710 is amended by revising paragraphs (b)(1) and (b)(3) to read as follows:

§ 627.2710 Grounds for appointment of conservators and receivers.

* * * * *

(b) * * *

(1) The institution is insolvent, in that the assets of the institution are less that its obligations to creditors and others, including its members. For purposes of determining insolvency, ''obligations to members'' shall not include stock or allocated equities held by current or former borrowers.

* * * * *

(3) The institution is in an unsafe and unsound condition to transact business, including having insufficient capital or otherwise. For purposes of this regulation, ''unsafe or unsound condition'' shall include, but shall not be limited to, the following conditions:

(i) For banks, a net collateral ratio of 102 percent.

(ii) For associations, collateral insufficient to meet the requirements of the association's general financing agreement with its affiliated bank.

(iii) For all institutions, permanent capital of less than one-half the minimum required level for the institution.

(iv) For all institutions, a relevant total surplus ratio of less than 2 percent.

(v) For associations, stock impairment.

* * * * *

Dated: September 17, 1997.

Floyd Fithian,

Secretary, Farm Credit Administration Board.

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DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. 97–NM–126–AD]

RIN 2120–AA64

Airworthiness Directives; Saab Model SAAB 2000 Series Airplanes

AGENCY: Federal Aviation Administration, DOT.

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: This document proposes the adoption of a new airworthiness directive (AD) that is applicable to certain Saab Model SAAB 2000 series airplanes. This proposal would require inspection of the two-way check valve on the engine fire extinguishing system for discrepancies, and corrective action, if necessary. This proposal is prompted by issuance of mandatory continued airworthiness information by a foreign civil airworthiness authority. The actions specified by the proposed AD are intended to prevent discrepancies of the check valve, which could result in improper functioning of the engine fire extinguishing system.