cotton classification requested by producers in 1998. Therefore, the 1999 producer's user fee for classification service is based on the 1998 base fee for HVI classification.

The fee was calculated by applying the formula specified in the Uniform Cotton Classing Fees Act of 1987, as amended by Public Law 102–237. The 1998 base fee for HVI classification exclusive of adjustments, as provided by the Act, was $2.12 per bale. A one percent, or two cents per bale increase due to the implicit price deflator of the gross domestic product added to the $2.12 results in a 1999 base fee of $2.14 per bale. The formula in the Act provides for the use of the percentage change in the implicit price deflator of the gross national product (as indexed for the most recent 12-month period for which statistics are available). However, this has been replaced by the gross domestic product by the Department of Commerce as a more appropriate measure for the short-term monitoring and analysis of the U.S. economy.

The number of bales to be classed by the United States Department of Agriculture from the 1999 crop is estimated at 16,810,410 bales. The 1999 base fee was decreased 15 percent based on the estimated number of bales to be classed (one percent for every 100,000 bales or portion thereof above the base of 12,500,000, limited to a maximum adjustment of 15 percent). This percentage factor amounts to a 32 cents per bale reduction and was subtracted from the 1999 base fee of $2.14 per bale, resulting in a fee of $1.82 per bale.

With a fee of $1.82 per bale, the projected operating reserve would be 46.66 percent. The Act specifies that the Secretary shall not establish a fee which, when combined with other sources of revenue, will result in a projected operating reserve of more than 25 percent. Accordingly, the fee of $1.82 must be reduced by 47 cents per bale, to $1.35 per bale, to provide an ending accumulated operating reserve for the fiscal year of 25 percent of the projected cost of operating the program. This will establish the 1999 season fee at $1.35 per bale.

Accordingly, § 28.909, paragraph (b) will be revised to reflect the increase in the HVI classification fees.

As provided for in the Uniform Cotton Classing Fees Act of 1987, as amended, a five cent per bale discount will continue to be applied to voluntary centralized billing and collecting agents as specified in § 28.909(c).

Growers or their designated agents requesting classification data provided on computer punched cards will continue to be charged the fee of 10 cents per card in § 28.910 (a) to reflect the costs of providing this service. Requests for punch card classification data represented only 0.7 percent of the total bales classed from the 1998 crop, down from 2.6 percent in 1997. Growers or their designated agents receiving classification data by methods other than computer punched cards will continue to incur no additional fees if only one method of receiving classification data was requested. The fee for each additional method of receiving classification data in § 28.910 will remain at five cents per bale, and it will be applicable even if the same method was requested. However, if computer punched cards were requested, a fee of ten cents per card will be charged. The fee in § 28.910 (b) for an owner receiving classification data from the central database will remain at five cents per bale, and the minimum charge of $5.00 for services provided per monthly billing period will remain the same. The provisions of § 28.910 (c) concerning the fee for new classification memoranda issued from the central database for the business convenience of an owner without reclassification of the cotton will remain the same.

The fee for review classification in § 28.911 will be increased from $1.30 per bale to $1.35 per bale.

The fee for returning samples after classification in § 28.911 will remain at 40 cents per sample.

List of Subjects in 7 CFR Part 28

Administrative practice and procedure, Cotton, Cotton samples, Grades, Market news, Reporting and recordkeeping requirements, Standards, Staples, Testing, Warehouses.

For the reasons set forth in the preamble, 7 CFR Part 28 is amended as follows:

PART 28—[AMENDED]

1. The authority citation for 7 CFR Part 28, Subpart D, continues to read as follows:

Authority: 7 U.S.C. 471–476.

2. In § 28.909, paragraph (b) is revised to read as follows:

§ 28.909 Costs.

* * * * *

(b) The cost of High Volume Instrument (HVI) cotton classification service to producers is $1.35 per bale.

* * * * *

3. In § 28.911, the last sentence of paragraph (a) is revised to read as follows:

§ 28.911 Review classification.

(a) * * * The fee for review classification is $1.35 per bale.

* * * * *

Dated: May 25, 1999.

Enrique E. Figueroa,

Administrator, Agricultural Marketing Service.

[FR Doc. 99–13764 Filed 5–27–99; 8:45 am]

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FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052–AB76

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Investment Management

AGENCY: Farm Credit Administration.

ACTION: Final rule.

SUMMARY: The Farm Credit Administration (FCA) adopts final investment management regulations that help Farm Credit System (System or FCS) banks and associations respond to rapid and continual changes in financial markets and instruments. The final regulations:

- Expand the list of high-quality investments that System banks and associations can purchase;
- Provide more flexibility to use comprehensive analytical techniques to manage risks at the portfolio or institutional level;
- Strengthen our requirements for sound investment management practices; and
- Streamline the requirements for investments in mortgage securities issued or guaranteed by the Federal Agricultural Mortgage Corporation (Farmer Mac).

EFFECTIVE DATE: These regulations will become effective 30 days after they are published in the **Federal Register** during which either one or both houses of Congress are in session. We will publish a notice of the effective date in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT: Laurie A. Rea, Senior Policy Analyst, Office of Policy Analysis, Farm Credit Administration, McLean, VA 22102–5090, (703) 883–4498; or Richard Katz, Senior Attorney, Office of General Counsel, Farm Credit Administration, McLean, VA 22102–5090, (703) 883–4020, TDD (703) 883–4444.

SUPPLEMENTARY INFORMATION:

I. Background

System banks may purchase eligible investments for the purpose of

maintaining a liquidity reserve, managing interest rate risk, and investing surplus funds. Farm Credit associations have authority to hold eligible investments to manage short-term surplus funds and reduce interest rate risk, subject to the approval of their funding banks.

Eligible investments help FCS banks and associations to control risks that result from their operations as single-industry agricultural lenders. On June 18, 1998, we proposed revisions to our investment management regulations.

The proposal balanced our desire to institute a disciplined investment management framework with the System's desire for more flexibility to respond to changing market conditions and advances in risk management and securities valuation.[1]

We proposed two fundamental changes to the existing investment regulations. First, we established guidelines for implementing an effective oversight and risk management process for investment activities. Second, our proposal expanded the list of eligible investments, and it relaxed or repealed many of the restrictions on investments that we previously authorized. For instance, we proposed to expand System bank and association investment authority to include a broader array of money market instruments, mortgage securities, and asset-backed securities.

Our proposal also balanced the System's need for greater flexibility regarding investments with essential safety and soundness controls, such as credit rating and diversification standards. Furthermore, our proposal continued to limit non-agricultural investments to 30 percent of each bank's total outstanding loans.

Overview of the Comments

The Presidents Finance Committee (PFC) for Farm Credit System banks, The Bond Market Association, and Farmer Mac commented on the proposed rule. All eight FCS banks fully supported the PFC's comments. The PFC's letter identified over 20 separate issues concerning investment management and eligible investments that the PFC asked us to address in the final rule. The Bond Market Association, which represents securities firms and investment banks that underwrite and trade debt securities, supported many of the System's positions on eligible investments. Farmer Mac's comments focused primarily on the different regulatory treatment of its mortgage securities and the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

Separately, we published a notice in the **Federal Register** that asked the public to identify existing FCA regulations and policies that impose unnecessary regulatory burdens on FCS institutions.[2] CoBank ACB and four Farm Credit associations asked us to reduce regulatory burden on the System by repealing or revising provisions in the existing investment regulations that pertain to the liquidity reserve requirement, association investments and the portfolio limit on Farmer Mac mortgage securities. We address these regulatory burden comments in the final investment rule.

We respond to these comments by making several substantive changes to the proposed investment management regulations and by rewriting the regulations so they are easier to understand. In addition, we also address commenters' questions and requests for clarification in the preamble.

II. Investment Activities of Associations and Service Corporations

We received several comments and questions about the investment authorities of associations, both in response to the proposed investment rule and our regulatory burden initiative. The PFC asked us to confirm that funding banks still retain the responsibility to review and approve the investments of their affiliated associations. In response to our regulatory burden initiative, three associations stated that the Farm Credit Act of 1971, as amended (Act) does not require the degree of bank oversight that redesignated § 615.5142 imposes on association investment activities. These associations suggested that funding banks should rely on the General Financing Agreements (GFA) to oversee the investment activities of their affiliated associations.

We modified final §§ 615.5131, 615.5133, 615.5140, 615.5141, 615.5142, and 615.5143 to confirm the existing investment authorities of associations and clarify that associations that elect to hold investments are expressly subject to regulations governing investment management, eligible investments, stress tests, and divestiture.

Redesignated § 615.5142 continues to authorize associations to acquire eligible investments that are listed in § 615.5140, with the approval of their funding banks, for the purposes of reducing interest rate risk and investing surplus funds. The final rule also retains the existing requirement that each System bank annually review the investment portfolio of every association that it funds.

Final § 615.5142 implements sections 2.2(10) and 2.12(18) of the Act, which require each funding bank to supervise and approve the investment activities of its affiliated associations. In response to comments that focused on the scope of bank supervision of association investments, we note that a number of satisfactory methods exist for System banks to oversee association investment activities under our regulatory framework. A bank may take an active role in advising and approving an association's investment decisions and strategies. For example, banks may provide research, analytical or advisory services that help associations to manage their investment portfolios. Alternatively, as suggested by three association commenters, the GFA can be an appropriate tool for funding banks to oversee the investment activities of their affiliated associations.

Bank oversight does not absolve an association's board and managers of their fiduciary duties to manage investments in a safe and sound manner. The fiduciary responsibilities of association boards of directors obligate them to develop appropriate investment management policies and practices to manage the credit, market, liquidity, and operational risks associated with investment activities. Additionally, it is incumbent upon each association's investment managers to fully understand the risks of its investments and make independent and objective evaluations of investments prior to purchase.

We incorporated explicit references to associations into final § 615.5133 to acknowledge the existing responsibility of associations to effectively manage their investments. We recognize, however, that associations have historically maintained few or no investments in non-agricultural financial instruments. The few associations that maintain investment portfolios hold primarily money market instruments and municipal securities. Therefore, the final regulation requires an association's board of directors to develop investment policies that are commensurate with its institution's investment activities.

An association's investment policies should be appropriate for the size, risk characteristics, and complexity of the association's investment portfolio and should be based on an association's unique circumstances, risk tolerances, and objectives. Associations must

[1] *See* 63 FR 33281.

[2] *See* 63 FR 44176 (Aug. 18, 1998); 63 FR 64013 (Nov. 18, 1998).

comply with all the requirements in § 615.5133 if the level or type of their investments could expose their capital to material loss. However, an association's board does not need to develop an investment policy if it elects not to hold non-agricultural investments authorized under § 615.5140.

Final § 615.5140, which lists eligible investments, is modified to clarify that it applies to associations. As noted earlier, associations already have the authority under redesignated § 615.5142 to hold eligible investments that are listed in § 615.5140. This revision more accurately reflects the scope of this regulation.

We take this opportunity to reiterate our long-standing position that service corporations, organized under section 4.25 of the Act, are subject to the investment regulations in subpart E of part 615. Although we have noted on past occasions that § 611.1136 of this chapter applies these investment regulations to both incorporated and unincorporated service organizations, questions about this issue have remained. Final § 615.5131(m) resolves this matter by expressly subjecting FCS service corporations that hold investments to these regulations. Service corporations that hold no investments are not required to develop investment policies or comply with § 615.5133.

III. Investment Management

We proposed significant changes to § 615.5133, which governs investment management practices and internal controls in the FCS. Our objective was to strengthen this regulation so each System institution would follow certain fundamental practices that enable its board and management to fully understand and effectively manage risks in its investment portfolio. An effective risk management process for investments requires financial institutions to establish: (1) Policies; (2) risk limits; (3) a mechanism for identifying, measuring, and reporting risk exposures; and, (4) a system of internal controls. As a result, the proposed rule required each Farm Credit board of directors to adopt policies that establish risk parameters and guide the decisions of investment managers. More specifically, we required board policies to establish objective criteria so investment managers can prudently manage credit, market, liquidity, and operational risks. Additionally, proposed § 615.5133 established other controls that help prevent loss, such as:

- Clear delegation of responsibilities and authorities to investment managers;
- Separation of duties;
- Timely and effective security valuation practices; and,
- Routine reports on investment performance.

A. Requests for Change

Only the PFC commented on proposed § 615.5133. Although the PFC supported the FCA's approach, it requested changes to three provisions of proposed § 615.5133. In response, we revised two of these regulations so they advance our safety and soundness objectives without placing unnecessary burden on the FCS. We resolved the PFC's third concern with a preamble explanation rather than a regulatory change. In addition to the two substantive amendments described above, we reorganized and rewrote this regulation so it is easier to understand and use.

1. Limits on Transactions With Each Securities Firm

The PFC asked us to eliminate the provision in proposed § 615.5133(a)(1)(ii) that requires investment policies to ''set limits on the amounts and types of transactions that the bank shall execute with authorized securities firms.'' [3] The PFC believes that this requirement is overly burdensome because the risk of loss from purchase and sale transactions with securities firms is negligible. The commenter also opined that this provision reduces the System's flexibility to trade with the securities firm that provides the best terms and execution for investment transactions.

The PFC persuaded us that some of the requirements in proposed § 615.5133(a)(1)(ii) might have inadvertently reduced the System's flexibility in executing transactions with various securities firms. However, we continue to believe that each System institution must carefully select and properly manage its relationships with securities firms as part of its efforts to manage credit risk associated with settlements on securities transactions. Thus, we respond to the PFC's concerns by revising the regulation so that the necessary safety and soundness constraints do not unreasonably hinder business relationships. In addition, this revision offers System institutions greater flexibility to trade with the securities firms of their choice.

Specifically, final and redesignated § 615.5133(c)(1)(ii) no longer obligates the board of directors to set specific limits on the amount and types of transactions that its institution executes with authorized securities firms. Instead, the final regulation requires System institutions to buy and sell eligible investments with more than one securities firm. As a result, the final rule still requires System institutions to diversify their exposure to credit risk from brokers, dealers, and investment bankers.

Nevertheless, final and redesignated § 615.5133(c)(1)(ii) still requires board policies to establish the criteria that investment managers will use to select securities firms. We have also retained the regulatory provisions that require each board of directors to:

- Annually review its criteria for selecting securities firms; and
- Determine whether its existing relationships with various securities firms should continue.

2. Reporting Investment Performance to the Board

The PFC expressed concern about a provision in proposed § 615.5133(e) that requires investment managers to report quarterly to the board on the performance and risk of ''each'' investment in the portfolio. According to the PFC, many FCS banks hold several hundred individual securities in sizeable investment portfolios. Under these circumstances, reporting to the board on every single investment is cumbersome and meaningful board review is difficult. The PFC suggests the reports to the board should summarize the risks associated with investment activities and address compliance with investment policies, objectives, risk limits, and regulatory requirements. The commenter further suggests that managers should report on individual investments only in exceptional circumstances.

We revise this provision to address the PFC's concern. Final and redesignated § 615.5133(g) requires management to report each quarter to its board of directors or a committee thereof on the performance and risk of each class of investments and the entire investment portfolio. Additionally, the final rule continues to require the report to identify all gains and losses that the institution incurs during the quarter on individual securities sold before maturity. We retained a reporting requirement on individual securities because it provides the board important and accurate information relating to the performance of investments and investment activity in general.

This new approach requires investment portfolio managers to provide System boards of directors

[3] The term ''securities firms'' in the final rule and this preamble collectively refers to brokers, dealers, and investment banks.

accurate, concise, meaningful, and timely information on the performance and risk of their institution's investments. This information helps the board to understand the risks inherent in the investment portfolio and oversee the investment activities of investment managers. We believe this revision removes burdensome reporting requirements from the final regulation while simultaneously promoting safe and sound investment management practices in the FCS. We have made no other modification to redesignated § 615.5133(g).

3. Securities Valuations

The only comment on securities valuation was from the PFC. The PFC asked us to delete proposed § 615.5133(d)(1), which requires System institutions to verify with an independent source the value of any security (other than a new issue) that they purchase or sell. The PFC interprets proposed § 615.5133(d)(1) as requiring FCS institutions to solicit a second bid for all securities from a competing broker, dealer, or other intermediary. The PFC warns that this requirement would undermine the good reputation of the System and cause its business relationships with securities firms to quickly deteriorate. As a result, the FCS would ultimately pay higher prices for securities and obtain lower yields.

We observe that nothing in the proposed regulation or preamble would require bids on investments from parties who compete with the seller, purchaser, counterparty, or other intermediary to a specific transaction. Instead, our regulation requires System banks, associations, and service corporations to verify the value of a security with an independent source. As the preamble to the proposed regulation notes, ''independent verification of a price can be as simple as obtaining a price from an industry recognized information provider.'' The same preamble passage also states that ''although price quotes from information providers are not actual market prices, they confirm whether the broker's price is reasonable.'' [4] This regulatory provision allows System institutions to independently verify the price of a security with an on-line market reporting service, such as Bloomberg, Telerate, or Reuters. Additionally, the regulation provides sufficient flexibility for System institutions to use internal valuation models to verify the reasonableness of prices that they pay or receive for securities. Moreover, independent verification of securities prices is a fundamental component of safe and sound investment management, and ensures that FCS institutions understand the value of their investments at purchase and sale.

In view of these considerations, we conclude that the requirement for independent verification of securities prices is appropriate and should be retained in the final regulation. We also made several stylistic changes to the securities valuation requirements, which we redesignated as final § 615.5133(f)(1).

B. Other Comments and Questions on Investment Management

We offer the following responses to requests for clarification on proposed § 615.5133 and additional guidance regarding investment management.

1. Are the FCA Regulations Consistent With the Federal Financial Institutions Examination Council's Policy on Investment Activities?

Yes. We confirm that § 615.5133 is consistent with the Federal Financial Institutions Examination Council's (FFIEC) ''Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities'' (Policy Statement).[5] We used the FFIEC's Policy Statement as a benchmark for developing this regulation. In our opinion, the FFIEC's guidance to other federally regulated financial institutions on sound investment management practices is suitable for the FCS. We encourage System institutions to refer to the FFIEC's Policy Statement when they devise, implement, and review policies that govern their investment management practices pursuant to § 615.5133. Additionally, FCS institutions should refer to our policy statement on interest rate risk management (FCA–PS–74) for further guidance on managing market risks.[6]

2. What Are the Responsibilities of Boards of Directors?

In general, the board of directors of any association or service corporation that holds eligible investments and every bank is responsible for establishing written investment policies that are appropriate for the size, types, and risk characteristics of its investments. Investment policies are a critical aspect of effective risk management and should set appropriate limits on exposure to credit, market, and liquidity risks. We emphasize that investment policies of each Farm Credit bank and any association or service corporation with significant investments should embody the following key elements.

Investment Objectives. A general explanation of the board's investment objectives, expectations, and performance goals is necessary to guide investment managers.

Risk Tolerance. Risk tolerance should be based on the strength of each institution's capital position and its ability to measure and manage risk. Additionally, risk limits should be consistent with broader business strategies and institutional objectives. Risk tolerance can be expressed through several parameters: duration, convexity, sector distribution, yield curve distribution, credit quality, risk-adjusted return, portfolio size, total return volatility, or value-at-risk.[7] Each institution should use a combination of parameters to appropriately limit its exposure to credit and market risk.

Asset Allocation. The board's asset allocation policy should ensure appropriate diversification within the various asset classes, as well as across the entire investment portfolio.[8] Final § 615.5140 eliminates the portfolio limits on many eligible investments, and therefore, we expect each bank, association, and service corporation to establish its own asset allocation guidelines. Investment parameters may include points where the investment portfolio should be reallocated or rebalanced to bring it back in line with the board's strategic asset allocation goals.

Asset Selection. The investment policy should identify the risk characteristics (*e.g.*, credit quality, price sensitivity, maturity, marketability or liquidity, maximum premiums or discounts, etc.) of investments that are suitable for inclusion in the investment portfolio.

Derivatives. Derivative instruments can be used to hedge risk, leverage a position or otherwise modify the risk profile of an investment portfolio. The board's investment policy should address the application of derivatives

[4] *See* 63 FR 33284 (June 18, 1998).

[5] *See* 63 FR 20191 (Apr. 23, 1998).

[6] *See* 63 FR 69285 (Dec. 10, 1998).

[7] Generically, duration is a measure of a bond or portfolio's price sensitivity to a change in interest rates. Convexity measures the rate of change in duration with respect to a change in interest rates. A sector refers to a broad class of investments with similar characteristics or industry classification. Yield curve distribution refers to the distribution of the portfolio's investments in short-term, intermediate, or long-term investments. Value-at-risk is a methodology used to measure market risk in an investment portfolio.

[8] Asset allocation is generally defined as the allocation of your investment portfolio across major asset classes, such as United States Treasury, corporate, mortgage or asset-backed securities.

within the portfolio and set appropriate limits on the use of derivatives.

Controls and Reporting Requirements. The investment policy should describe the duties and responsibilities of the investment manager(s), set the delegation of authorities, outline any prohibited investments or activities, and specify the content and frequency of reports to the board on investment activities.

3. What Analysis Must Management Perform on Individual Investments Prior to Purchase and on an Ongoing Basis?

Not all investment instruments need an extensive pre-purchase or post-purchase analysis. Non-complex instruments that have minimal price sensitivity need little or no pre-purchase analysis. Final and redesignated § 615.5133(f) (previously proposed § 615.5133(d)(3)) generally requires System banks to perform an analysis of the credit and market risks on investments prior to purchase and on an ongoing basis. The primary objective of this provision is to ensure that management understands the risks and cashflow characteristics of any investment that it purchases. The board's investment policy should fully address the extent of the pre-purchase analysis that management needs to perform for various classes of instruments. For example, the policy should specifically indicate which stress tests in § 615.5141 should be performed on various types of mortgage securities.

For investments that have unusual, leveraged, or highly variable cashflows, it is especially important for investment managers to exercise diligence and thoroughness in making investment decisions. Managers should have a reasonable and adequate basis, supported by appropriate analysis for their investment decisions, and maintain adequate documentation. The analysis should describe the basic risk characteristics of the investment and include a balanced discussion of risks involved in purchasing the investment. In preparing the analysis, investment managers should consider the current rate of return or yield, expected total return, annual income, the degree of uncertainty associated with the cashflows, the investment's marketability or liquidity, as well as its credit and market risks.

4. What Investment Management Approach Does the FCA Prefer?

The PFC asked us to clarify when we expect System institutions to manage their investments on an individual, portfolio or institutional basis. The appropriate level of risk management depends on the complexity of instruments and the size of your investment portfolio. A System institution may need to analyze risk on an individual, portfolio, and institutional level. As appropriate, stress testing should be performed on individual investments, the investment portfolio or the entire institution. Additionally, other risk management techniques, such as total return analysis or value-at-risk, may be used to effectively manage risk exposures.

When a new investment position is likely to significantly alter the risk profile of an institution, management should complete an analysis of the potential effects on the portfolio and the entire institution prior to purchasing the investment. Although investors have traditionally looked at investments one at a time, modern portfolio theory suggests that investors should look at the effect of individual investments on the entire portfolio. Often, investments that seem acceptable on an individual basis have a significant exposure to a single risk factor on a cumulative basis. Conversely, under the portfolio approach, financial institutions may hold individual investments that are fairly risky, if the risks are offset by other investments or derivative instruments. As a result, the portfolio approach allows investment managers to achieve higher returns while maintaining overall portfolio risk at a reasonable level.

System institutions should tailor their investment management approach to meet their needs based on the type and level of their investment activities and unique risk profile. Regardless of the approach taken, each Farm Credit bank, association, and service corporation should ensure that it is able to effectively measure, monitor, and control the credit, market, liquidity, and operational risks stemming from its investment activities. This requires an understanding of the source and degree of the institution's risk exposures and how these risk exposures may change under differing economic scenarios.

III. Eligible Investments

A. Overview

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. Similarly, redesignated § 615.5142 (formerly § 615.5141) authorizes FCS associations to hold eligible investments listed in § 615.5140 to invest surplus funds and reduce interest rate risk. Only investments that can be promptly converted into cash without significant loss are suitable for achieving these objectives. For this reason, the eligible investments listed in § 615.5140 generally have short terms to maturity and high credit ratings from nationally recognized statistical rating organizations (NRSROs). Furthermore, all eligible investments are either traded in active secondary markets or are valuable as collateral.

We proposed to amend § 615.5140 so System banks and associations could purchase and hold a broader array of high-quality and liquid investments. As a result, the proposed regulations expanded the list of eligible investments and relaxed or repealed certain restrictions in § 615.5140. These revisions reflect changes in the financial markets and help fulfill our objective of developing a regulatory framework that can more readily accommodate innovations in financial products and analytical tools.

Two commenters, the PFC and The Bond Market Association, generally supported our proposal to amend § 615.5140. The commenters also asked us to approve other instruments that would offer higher yields and further diversify the investment portfolios of System institutions. As we explain in greater detail below, we incorporated many of the commenters' suggestions into final § 615.5140. In addition, as part of our efforts to write regulations that are easier to understand and use, we converted most of § 615.5140 into a chart.

We received no comments on proposed § 615.5140(a)(1), (a)(3), (a)(7), and (a)(8), which respectively authorize FCS banks and associations to invest in:

- Securities that are issued or guaranteed by the United States, its agencies, or instrumentalities;
- Obligations of international and multilateral development banks;
- Corporate debt obligations; and
- Shares of investment companies that register under the Investment Company Act of 1940 (*e.g.*, money market mutual funds).

Accordingly, we made no substantive changes to § 615.5140(a)(1), (a)(3), (a)(7), and (a)(8).

State and Municipal Securities

Existing § 615.5140(a)(10) authorizes System banks and associations to invest in the general obligations of State and municipal governments. We proposed to redesignate this provision as § 615.5140(a)(2) without significant change. However, we added a definition of ''general obligation of a State or political subdivision'' to § 615.5131 to

codify our recent guidance on bonds guaranteed by the full faith and credit of a State or local government.[9] We rewrote the definition to make it clear and we now adopt §§ 615.5140(a)(2) and 615.5131(e) as final regulations.

Prior to this rulemaking, System banks requested authority to invest in revenue bonds. Revenue bonds are not supported by the taxation powers of the obligor, and are repayable from fee income and other sources of revenue. We requested input on how the final regulation could authorize investments in revenue bonds while limiting risks to System institutions. More specifically, we solicited comments on how the final regulation could establish:

- Criteria for determining which revenue bonds meet the investment purposes in § 615.5132; and
- Appropriate limits on the amount of these investments.

We received only one comment concerning municipal securities. The PFC suggested that all highly rated revenue bonds should be eligible investments. The PFC believes that highly rated revenue bonds are suitable for meeting liquidity and interest rate risk management objectives.

Municipal revenue bonds may provide FCS banks and associations with another suitable investment to diversify their portfolios. The universe of municipal revenue bonds is diverse and some, but not all, of these instruments are actively traded in established secondary markets. Although the full faith and credit of a governmental entity with taxation powers does not back municipal revenue bonds, these instruments usually enjoy an implicit guarantee of the State government. For these reasons, we add municipal revenue bonds as eligible investments, subject to certain safety and soundness controls. Final § 615.5140(a)(2) authorizes FCS banks and associations to invest in municipal revenue bonds that are rated in the highest investment rating category by an NRSRO and mature within 5 years or less. The final regulation requires the investing System bank or association to document, at the time of purchase, that the particular issue is actively traded in an established secondary market. Additionally, these investments are subject to a 15-percent portfolio limit. We also added a conforming definition of ''revenue bonds'' to final § 615.5131.

C. Money Market Instruments

We proposed several changes to the provisions in § 615.5140 that authorize FCS banks and associations to invest in money market instruments. Under our proposal, all money market instruments were grouped together into a single regulatory provision, § 615.5140(a)(4). We proposed to repeal existing limitations on the amounts of negotiable certificates of deposit, Federal funds (Fed Funds), bankers acceptances, and prime commercial paper that each FCS institution can hold in its investment portfolio. We also added Eurodollar time deposits and master notes to the list of eligible money market investments.

Only the PFC commented on proposed § 615.5140(a)(4). The commenter asked us to: (1) Repeal the ''callable'' requirement for Term Federal Funds; and (2) clarify the credit rating requirements for repurchase agreements and master notes.

1. Term Federal Funds

From the commenter's perspective, our insistence that System institutions invest only in negotiable Term Fed Funds is inconsistent with our approach toward Eurodollar time deposits. The PFC pointed out that proposed § 615.5140(a)(4) granted System institutions new authority to invest in non-negotiable Eurodollar time deposits, which are very similar to Term Fed Funds in terms of credit, liquidity, and market risks. The PFC asserts that Term Fed Funds do not need a ''callable'' feature to make them liquid because our regulation already requires them to maintain a high credit rating and mature within 100 days. Thus, the PFC urges us to delete the provision in § 615.5140(a)(4)(i) that requires all Term Fed Funds to be ''callable.''

The PFC persuaded us that highly rated Term Fed Funds that mature within 100 days are suitable investments, even if they are not ''callable.'' Thus, we amended this provision so final § 615.5140(a)(4) no longer requires System banks and associations to invest only in ''callable'' Term Fed funds.[10] This change will provide System institutions with additional flexibility to invest with counterparties that do not offer ''callable'' features on Term Fed Funds.

In addition, the final regulations apply consistent treatment of investments in Term Fed Funds and Eurodollar time deposits. Final § 615.5140 subjects non-callable Term Fed Funds to the same 20-percent portfolio limit as Eurodollar time deposits. From a safety and soundness perspective, this portfolio limit is necessary to limit the amount of non-negotiable instruments that are held in bank and association investment portfolios. The final regulation continues to place no portfolio limit on the amount of ''continuously callable'' Term Fed Funds that FCS banks and associations can hold. Like Eurodollar time deposits, non-callable Term Fed Funds must also be invested at depository institutions with the highest short-term credit rating from an NRSRO.

2. Response to Comments on Credit Ratings

a. *When are short-term or long-term credit ratings appropriate for the collateral securing repurchase agreements?* Final § 615.5140(a)(4) allows System banks and associations to invest in repurchase agreements that are backed either by: (1) Eligible investments; or (2) other marketable securities that are rated in the highest credit rating category by an NRSRO. The type of collateral should determine whether a short-term or a long-term credit rating is appropriate. System banks and associations may use an equivalent long-term rating if it is the only credit rating available for a short-term financial instrument held as collateral in a repurchase agreement.

b. *Are long-term credit ratings appropriate when no short-term ratings are available for counterparties to master note agreements?* Yes. We recognize that certain institutions that are counterparties to master note agreements may only have long-term credit ratings from an NRSRO. When short-term credit ratings are unavailable, System institutions may use an equivalent long-term rating to determine if the money market instrument is eligible under our regulations. For example, we consider an ''A–1'' short-term rating from Standard and Poor's (S&P) to be the equivalent to a ''AA'' or higher long-term S&P rating.

D. Mortgage Securities

1. *Overview*

We proposed significant changes to the authority of FCS institutions to invest in mortgage securities. The proposal expanded the list of eligible investments to include certain non-agency mortgage securities and stripped mortgage-backed securities (SMBS). We proposed these amendments to grant FCS banks and associations more options for managing risks and diversifying their portfolios.

Both the PFC and The Bond Market Association suggested additional revisions to the regulation, and asked us

[9] *See* FCA BL–038, ''Guidance Relating to Investment Activities,'' Nov. 26, 1997).

[10] In the final regulations, Term Fed Funds are defined as having a maturity between 2 and 100 business days.

several questions about the proposed requirements. They recommend that we grant FCS banks and associations authority to invest in: (1) Mortgage securities that are rated within the two highest rating categories by an NRSRO, (2) multifamily mortgage securities, and (3) non-agency commercial mortgage-backed securities (CMBS). In response to these comments, we revised § 615.5140(a)(5) so System banks and associations can invest in a broader array of mortgage securities.

2. Credit Ratings

Both the PFC and The Bond Market Association asked us to authorize investments in mortgage securities that are rated in the ''two'' highest (rather than only the highest) credit rating categories of an NRSRO. The commenters assert that investment grade mortgage securities in general have exhibited a remarkable credit performance history. Over the past 20 years, few mortgage security issues have experienced credit-related problems. Furthermore, the two highest credit ratings would correspond with the criteria in the Secondary Mortgage Market Enhancement Act of 1984.[11]

After carefully considering the commenters' input and weighing the potential risks, we did not adopt the suggestion to lower the credit rating for mortgage securities. There is an ample assortment of mortgage securities in the highest investment credit rating category that System banks and associations can use for liquidity, cash and interest rate risk management. We believe the final regulation maintains the high credit quality of System investments without depriving System institutions of any significant opportunity to invest in mortgage securities.

3. Mortgage Securities that are Issued or Guaranteed by the United States

We made a technical correction to the provision that allows FCS banks and associations to invest in mortgage securities that are issued or fully guaranteed by the United States. Our proposal omitted language in the former regulations that authorize investment in securities that are backed by mortgages that are guaranteed as to both principal and interest by the full faith and credit of the United States. Final § 615.5140(a)(5) allows System banks and associations to invest in mortgage securities that are:

- Issued or guaranteed by the Government National Mortgage Association (GNMA); or
- Secured by mortgages that are guaranteed as to both principal and interest by the full faith and credit of the United States.

This provision extends to mortgage securities issued by the Small Business Administration (SBA) or other Federal government agencies if the full faith and credit of the United States back the principal and interest payment of the underlying mortgages. All mortgage securities that System banks and associations purchase under § 615.5140(a)(5) must comply with the stress-testing requirements in § 615.5141.

4. Agency Mortgage Securities

We made no changes to FCS institutions' authorities to invest in residential mortgage securities that are:

- Issued by Fannie Mae and the Freddie Mac; or
- Issued under a private label but are collateralized by Fannie Mae or Freddie Mac mortgage-backed securities.

System banks, however, suggested that we add Fannie Mae Delegated Underwriting and Servicing (DUS) bonds to the list of eligible investments. Fannie Mae DUS bonds are mortgage securities backed by multifamily mortgage loans. They carry the Fannie Mae guarantee on the timely payment of principal and interest. They also have low prepayment risk due to yield maintenance agreements, prepayment lockouts, and prepayment fees. We agree that agency mortgage securities backed by multifamily loans are suitable investments for FCS institutions. Therefore, we amended the definition of ''mortgage securities'' in § 615.5131(i) to clarify that FCS banks and associations have the authority to invest in Fannie Mae DUS bonds and other mortgage securities on multifamily residential properties that are issued or guaranteed by Federal agencies and instrumentalities. Agency mortgage securities that are secured by multifamily loans must meet the stress-testing requirements of § 615.5141.

5. Portfolio Limits on Fannie Mae and Freddie Mac Mortgage Securities

Two commenters, the PFC and The Bond Market Association, asserted that the 50-percent portfolio limit on Fannie Mae and Freddie Mac mortgage securities is overly restrictive and unprecedented. According to these commenters, the credit risk on these securities is almost non-existent and no other financial regulatory agency places any restrictions on the amount of these securities.

After a thorough evaluation of these comments, we decided not to eliminate the portfolio limit on Fannie Mae and Freddie Mac mortgage securities. We believe that regulatory portfolio limits enhance safety and soundness by promoting diversification of System investment portfolios and curtailing investments in securities that may exhibit considerable interest rate risk. The final regulation greatly expands the types of mortgage securities that are eligible investments. Under the circumstances, we believe portfolio limits are an appropriate regulatory tool for controlling the System's market risk exposure from these instruments.

We did, however, make one important modification to the proposed portfolio limits in response to the commenters' concerns. Under the final regulations, the 50-percent limit on agency mortgage securities is now separate from the 15-percent limit on non-agency residential and commercial mortgage securities. The new portfolio limits accommodate the System's desire for greater opportunities to invest in mortgage securities.

We emphasize that the board and management of each System bank, association, or service corporation are responsible for establishing exposure limits on all types of mortgage securities. Regulatory portfolio limits on certain mortgage securities do not absolve an institution's board or management of its responsibility to set limits based on its unique risk-bearing capacity, management capabilities, and objectives. Moreover, the board of directors of each System bank or association has a fiduciary duty to maintain a well-diversified investment portfolio to reduce the risk of substantial loss. We also expect FCS banks and associations to diversify their investments within each major asset class.

6. Non-Agency Mortgage Securities

Our proposal would authorize System institutions to invest in mortgage securities that are offered by private entities.[12] Under the proposal, only the highest rated privately issued securities that are collateralized by qualifying residential mortgages meeting the collateral requirements of the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA), would be eligible investments.[13] SMMEA securities must generally be secured by a first lien on

[11] *See* Pub. L. 98–440, 98 Stat. 1689 (Oct. 3, 1984).

[12] *See* proposed § 615.5140(a)(5)(ii).

[13] The proposed rule allows investments in mortgage securities that are offered and sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. 77d(5) or are residential mortgage-related securities within the meaning of section 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41).

a single parcel of real estate (residential or mixed residential commercial structure) and originated by a qualifying financial institution.[14] Our proposal required System banks and associations to subject these mortgage securities to a stress test under § 615.5141 prior to purchase.

System banks requested additional authority to invest in mortgage securities that are collateralized by mortgages on commercial properties, such as apartment buildings, shopping centers, office buildings, and hotels. CMBS typically have yield maintenance provisions or other features that provide greater prepayment protection to investors than residential mortgage securities.[15] However, CMBS are more difficult to analyze in terms of credit risk. The structure of CMBS securities can vary widely and the more unique structures may contain additional risks that need to be thoroughly evaluated. The CMBS market is relatively young and has recently experienced liquidity problems.

On balance, we conclude CMBS with appropriate safety and soundness controls may help Farm Credit banks achieve greater portfolio diversification and risk-adjusted returns. We, therefore, authorized investments in CMBS that are rated in the highest credit rating category by an NRSRO and supported by no less than 100 mortgage loans that are geographically dispersed. Additionally, no single obligor can be the mortgagor on more than 5 percent of the loans in the entire mortgage pool. The final regulation subjects CMBS to the same portfolio cap as non-agency mortgage securities. As a result, the combined investment in CMBS and non-agency mortgage securities cannot exceed 15 percent of the total investment portfolio.

Prudent investment practices require investment managers to fully understand the cashflow characteristics and price sensitivity of CMBS investments. Thus, we require System institutions to subject CMBS investments to stress testing in accordance with § 615.5141. Furthermore, System banks should rely on evaluation methodologies that take into account all the risk elements in CMBS investments. In this regard, we stress the importance of making an independent and critical evaluation of the security's credit and liquidity risks prior to purchase, and on an ongoing basis.

7. Other Mortgage-Derivative Products

The FCA proposed to repeal existing §§ 615.5131(r) and (s), 615.5140(a)(2)(v), and certain provisions in § 615.5174(c) that explicitly ban investments in SMBS and inverse floating-rate debt classes. We concluded that the explicit regulatory ban on certain mortgage-derivative products (MDP) is unnecessary because all mortgage securities are subject to stress-testing requirements. We received no comments regarding these proposed changes, and therefore adopt this provision as a final rule.

However, certain MDP (such as SMBS) may pose substantial risks to the System institutions, and, therefore we take this opportunity to reiterate the importance of effective risk management and to provide additional guidance. Although we recognize that MDP can be useful tools for reducing interest rate risk, certain MDP are risky because their prices may be subject to substantial fluctuations. Successful risk management of these instruments requires a thorough understanding of the principles that govern the pricing of these instruments. The degree of price sensitivity that a mortgage security exhibits to changes in market interest rates is influenced by its unique characteristics. A System institution should determine whether a particular mortgage security meets its risk management objectives by using analytical techniques and methodologies that effectively evaluate how interest rate changes will affect prepayments and cashflows of the instrument.

Investment managers must have a reasonable basis for making investments in MDP that exhibit significant price sensitivity and maintain appropriate records to support their investment decisions. In general, the FCA would view it as an unsafe and unsound practice for FCS banks and associations to hold highly price-sensitive MDPs, such as interest-only or principal-only SMBS, for any purpose other than to reduce specific interest rate risks. Managers must document, prior to purchase and each quarter thereafter, that the MDP is reducing the interest rate risk of a designated group of assets or liabilities and the interest rate risk of the institution.

E. Asset-Backed Securities

1. An Overview of Our Proposal and Summary of Comments

Our proposal expanded the collateral for eligible asset-backed securities (ABS) to include student loans, manufactured housing loans, wholesale dealer automobile loans, equipment loans and home equity loans. Under these regulations, securities collateralized by home equity loans qualify as ABS, not mortgage securities. Proposed § 615.5140(a)(6) specified that the weighted average life (WAL) for all eligible ABS could not exceed 5 years and the final maturity could not exceed 7 years. We further proposed that all eligible ABS achieve the highest credit rating from an NRSRO, and we suggested a 20-percent portfolio cap on these investments. We also solicited your comments on how we could develop a more flexible regulatory framework that could effectively respond to new innovations in the ABS market.

The PFC and The Bond Market Association responded to our proposal on ABS. They asked us to revise the provisions in proposed § 615.5140(a)(6) relating to ABS maturity, collateral, and credit rating requirements and the portfolio limit. In response, we made several modifications to these proposed provisions, which are explained below.

2. Final Maturity

The PFC and The Bond Market Association advised us that the combination of a 5-year WAL and a final maturity of 7 years would effectively prevent System banks and associations from investing in some of the most liquid segments of the ABS markets. As a result, both commenters asked us to omit the provision that establishes a final maturity for ABS from final § 615.5140(a)(6).

We conclude that the commenters' suggestion has merit. Generally, the WAL is the average amount of time required for each dollar of invested principal to be repaid, based on the cashflow structure of an ABS and an assumed level of prepayments. In contrast, the final maturity of an ABS refers to the date that the final principal payment on the underlying collateral is due. Nearly all ABS are priced and traded on the basis of their WAL. We agree that the 7-year final maturity restriction in the proposed rule would have effectively foreclosed the System's ability to invest in ABS that are backed by certain types of collateral, especially manufactured housing and home equity loans. Therefore, the final rule does not

[14] *See* SMMEA amended section 3(a)(41) of the Securities Exchange Act of 1934.

[15] ''CMBS'' refers only to non-mortgage securities on commercial real estate. This term does not cover Fannie Mae mortgage securities on mixed residential and commercial properties or mortgage securities on commercial real estate that the SBA issues or guarantees.

impose a maximum final maturity on ABS.

3. Adjustable Rate ABS

The PFC also asked us to modify the maturity guidelines for adjustable rate ABS so that they are more consistent with the criteria for adjustable rate mortgage securities. The preamble to the proposed rule noted that repricing frequency, periodic life caps, and the underlying index are important determinants of how a floating rate ABS performs and its interest rate risk profile.[16] Although the PFC generally agreed with this statement, it pointed out that the maturity (whether defined as WAL, expected final or legal final maturity) will not provide much insight into the interest rate risk profile of the instrument. The PFC also noted that these securities have minimal price sensitivity and interest rate risk because most adjustable rate ABS: (1) Frequently reprice off a recognized index; (2) are uncapped; or (3) have very high lifetime interest rate caps. We agree and we have modified the regulations to address these concerns. Under the final regulations, the expected WAL on eligible ABS must not exceed:

- Five (5) years for a fixed rate security or floating rate security at its contractual interest rate cap;
- Seven (7) years for a floating rate security without a cap or floating rate security that remains below its contractual interest rate cap.

4. Collateral and Credit Ratings

The PFC suggests that final § 615.5140(a)(6) authorizes System banks to invest in any ABS that is rated in the two highest credit rating categories by an NRSRO once a liquid market is established. The PFC believes that its suggestion would expand the System's opportunities to invest in the ABS market while preventing System banks and associations from acquiring individual securities that are illiquid. The PFC asserts that a high credit rating is indicative of whether an ABS is liquid. The commenter supports its position by pointing out that the secondary market for ABS is now larger than the secondary market for Collateralized Mortgage Obligations (CMOs). If we adopted this approach, the final regulation would not restrict the types of collateral that back eligible ABS.

We did not incorporate the PFC's suggestion into final § 615.5140(a)(6). This regulation allows System banks and associations to invest in most ABS that are available in the financial markets. Although the ABS market now outpaces the CMO market, the secondary market for ABS issues secured by other types of collateral is more limited. The PFC acknowledges in its comment letter that its suggestion may not necessarily be a reliable gauge of liquidity in ABS markets. Final § 615.5140(a)(6) provides System institutions ample opportunities to invest in highly rated, fixed-income ABS that offer stable cashflows. Furthermore, the FCA will consider approval of other types of ABS on a case-by-case basis under final § 615.5140(e).

5. Portfolio Limit

We did not incorporate The Bond Market Association's suggestion to increase the portfolio limit on ABS from 20 to 50 percent. The ABS market primarily developed during a period of prolonged economic growth, and, for the most part, the performance of the ABS market has not been tested under significant economic stress. For this reason, we are reluctant to increase the System's exposure to ABS investments at this time.

Separately, System institutions asked us to explain how § 615.5140 applies to senior ABS that are secured by student loans the United States Department of Education conditionally guarantees. These securities are backed by loans that are conditionally guaranteed by the United States Department of Education through a program that reinsures the guarantees of loans by State and nonprofit agencies. The portion of the security that the United States Department of Education does not conditionally guarantee must be counted toward the 20-percent ABS limit. The portfolio limit does not apply to the portion of the security that the United States guarantees. This treatment is consistent with our approach of placing no portfolio restrictions on investments in obligations that are insured or guaranteed by the United States or its agencies. Obligations that are insured or guaranteed by the United States or its agencies are authorized under § 615.5140(a)(1).

F. Approval Process for Other Investments

We solicited comments on how final § 615.5140 could permit FCS banks and associations to invest in highly rated marketable securities that are not expressly authorized by § 615.5140 without requiring FCA approval. System banks suggested that the FCA should pursue a more general and broader approach to risk management and establish a set of price volatility guidelines that could be applied to all types of investments. After considering this suggestion, we concluded, for the reasons explained below, that this suggestion is not an effective replacement for the prior approval requirement in § 615.5140.

We make no changes in our process for approving investments not listed in § 615.5140 for several reasons. We designed final regulations that would grant FCS banks more flexibility to manage risk in accordance with their own unique risk tolerance and objectives. For example, FCS institutions now have the option under § 615.5141 to establish their own internal price volatility guidelines for mortgage securities. Furthermore, the final regulations expand the list of eligible investments and remove or relax regulatory restrictions on other authorized investments. Together, these amendments provide each FCS bank with a broader selection of investments so it can establish a well diversified investment portfolio that will enable it to maintain a liquidity reserve, invest surplus funds, and manage interest rate risks. Similarly, § 615.5133 places the primary responsibility for identifying, measuring, and managing risk with each System institution. This provision allows each FCS institution to set its own risk tolerance levels based on its unique circumstances.

Furthermore, establishing a single set of price volatility guidelines that applies to all types of investments and all System banks and associations is inconsistent with our new regulatory approach. We believe we can achieve our safety and soundness objectives by placing greater emphasis on effective investment and risk management practices within the System. Therefore, the final regulations continue to require System institutions to seek our approval before they purchase investments not listed in § 615.5140.

G. Equity Investments

CoBank, ACB, responded to our initiative on regulatory burden by suggesting that we amend § 615.5140 so FCS banks could hold equity investments in borrowers and other third parties who form strategic alliances to serve System customers. These types of investments further the System's mission to finance agriculture and rural communities, but usually they are not suitable for managing liquidity and market risks at System institutions. We plan to initiate a rulemaking in the future that will address the authority of FCS banks and associations to hold equity investments that are related to their agricultural credit mission.

[16] *See* 63 FR 33281, 33289 (June 18, 1998).

Accordingly, we will address CoBank's request at that time.

IV. Stress Testing for Mortgage Securities

We adopt the requirements for stress testing mortgage securities in § 615.5141 as a final regulation without substantive amendment. However, we did receive several questions and comments regarding stress testing that require a response.

Prior to this rulemaking, FCS banks requested technical modifications to our existing regulatory stress tests. System banks subsequently requested that we repeal the regulatory stress tests after the FFIEC rescinded a policy statement that required depository institutions to stress test mortgage-derivative products.[17] System banks commented that the FCA should make its regulatory approach consistent with the FFIEC's new policy. In response, we proposed significant changes to existing requirements for evaluating the price sensitivity of mortgage securities and determining their suitability. We, however, did not propose to rescind the stress-testing requirement for mortgage securities.

We concluded that stress testing is an essential risk management practice for several reasons. Although credit risk on highly rated mortgage securities is minimal, mortgage securities may expose investors to significant interest rate risk. Since borrowers may prepay their mortgages, investors may not receive the expected cashflows and returns on these securities. Additionally, numerous factors influence the cashflow pattern and price sensitivity of mortgage securities. Prepayments on these securities are affected by the spread between market rates and the actual interest rates of mortgages in the pool, the path of interest rates, and the unpaid balances and remaining terms to maturity on the mortgage collateral. The price behavior of a mortgage security also depends on whether the security was purchased at a premium or at a discount. As a result of these factors, we concluded that each System institution needs to employ appropriate analytical techniques and methodologies to measure and evaluate interest rate risk inherent in mortgage securities. More specifically, prudent risk management practices require every System institution to examine the performance of each mortgage security under a wide array of possible interest rate scenarios.

Our proposal allowed each System institution to accomplish this performance analysis by choosing between two options for stress testing mortgage securities. Under the first option, an FCS institution could continue to use a modified version of the existing three-pronged stress test in § 615.5141(a). The three tests include an average life test, an average life sensitivity test, and a price sensitivity test.

The Bond Market Association suggested that we eliminate the standardized stress tests in § 615.5141(a) because a risk management program that requires a financial institution to identify, measure, monitor, and control risk on an institutional or portfolio level is more effective than a pass/fail test for individual instruments.

However, we elect to retain the three-pronged stress test in § 615.5141(a) as a viable option for System institutions. Our reasoning for this decision stems from our concerns about additional resources, costs, and expertise associated with more comprehensive analytical techniques needed to effectively manage risk at the portfolio or institutional level. From a historical perspective, the tests in § 615.5141(a) successfully protected Farm Credit banks from significant losses in certain mortgage products. By requiring the pre-purchase and quarterly price sensitivity analysis, System banks were better able to understand the risks associated with their investments.

Under the second stress-testing option, proposed § 615.5141(b) allowed the use of alternative stress test criteria and methodologies to evaluate the price sensitivity of mortgage securities. We proposed this alternative because new risk management techniques better enable investors to measure interest rate risks in complex mortgage securities. We also emphasized that alternate stress tests must be able to measure the price sensitivity of mortgage instruments over different interest rate and yield curve scenarios. Furthermore, the methodology must be commensurate with the complexity of the instrument's structure and cashflows. For example, a pre-purchase analysis should show the effect of an immediate and parallel shift in the yield curve of plus and minus 100, 200, and 300 basis points. An instrument's complexity determines whether the risk analysis should encompass a wider range of scenarios, including non-parallel changes in the yield curve. A comprehensive analysis may also take into consideration other relevant factors. Most importantly, the methodology that each System bank or association uses to evaluate an instrument's suitability must be able to determine that a particular mortgage security:

- Meets the objectives and risk limits in its investment policies; and
- Does not expose the capital and earnings of the institution to excessive risk.

We received one comment from the PFC on proposed § 615.5141(b). The PFC requested clarification on whether the board or the management of each FCS bank and association is responsible for establishing the risk parameters of alternate stress tests. If the board elects to use alternative stress tests as permitted under § 615.5141(b) to gauge market risk in mortgage securities, it must also assume responsibility for establishing the risk parameters for the stress test.

In further response to the PFC, we reaffirm that § 615.5141(b) is consistent with the guidance in the FFIEC's policy statement regarding stress testing mortgage securities. Our new approach, which we now adopt as a final regulation, enables System banks and associations to rely on more comprehensive analytical techniques that enhance their risk management. Our regulations no longer prevent System banks and associations from holding mortgage securities solely on the basis that they exhibit significant price sensitivity. The final regulation affords FCS banks and associations the latitude to consider a number of factors when evaluating a mortgage security's suitability. For example, System banks and associations may consider interest rate volatility, changes in credit spreads, an instrument's total return or whether the instrument reduces the overall risk in the investment portfolio or throughout the institution.

The PFC inquired whether derivative hedge transactions could be considered when determining whether a mortgage security is an eligible investment. We confirm that FCS institutions may consider the effect of derivative hedge transactions on the price sensitivity of instruments as part of their evaluation of whether a particular mortgage security is a suitable investment under either § 615.5141(a) or (b).

V. Farmer Mac Mortgage Securities

1. Our Proposal

We proposed technical amendments to § 615.5174, which authorizes FCS banks and associations to invest in mortgage securities that are issued or guaranteed by Farmer Mac. Basically, we intended to revise § 615.5174 so it conforms to amendments in subpart E of part 615. More specifically, these technical amendments would:

[17] *See* 63 FR 20191 (Apr. 23, 1998).

• Delete cross-references to the former definitions of ''mortgage-backed securities,'' ''collateralized mortgage obligations,'' ''Real Estate Mortgage Investment Conduits,'' and ''adjustable rate mortgages'' in § 615.5131; and

• Repeal existing § 615.5174(c), which prohibits FCS banks and associations from investing in Farmer Mac stripped mortgage-backed securities.

2. Summary of Comments

Two commenters requested substantive revisions to § 615.5174. Farmer Mac asked us to amend our regulations to equalize the regulatory treatment of mortgage securities of Farmer Mac, Fannie Mae, and Freddie Mac. Farmer Mac asserts that our original justification for according Farmer Mac mortgage securities a different regulatory treatment than Fannie Mae and Freddie Mac mortgage securities is no longer valid. Farmer Mac points out that 2 years after we adopted existing § 615.5174, Congress enacted the Farm Credit System Reform Act of 1996 [18] (1996 Act), which repealed several statutory provisions that distinguished its mortgage securities from those of Fannie Mae and Freddie Mac. As a result of these statutory changes, Farmer Mac asserts that the spreads of Farmer Mac mortgage securities are now close to those on comparable Fannie Mae and Freddie Mac products. For these reasons, Farmer Mac believes that the mortgage securities of all three GSEs expose investors to approximately the same risk of loss and should be treated in a similar fashion.

The jointly managed Central Coast Production Credit Association/Federal Land Credit Association (Central Coast) responded to our notice on regulatory burden by encouraging us to repeal the 20-percent portfolio limit on Farmer Mac mortgage securities in existing § 615.5174(a). As the commenter notes, we enacted this portfolio limit in 1993, when the Act required System banks and associations to guarantee 10 percent of Farmer Mac mortgage securities through either a cash reserve or a subordinated participation interest in the underlying loans. The associations assert that the original safety and soundness rationale for the 20-percent portfolio limit no longer exists because Farmer Mac now has the authority both to issue mortgage securities and to fully guarantee principal and interest payments to investors.

[18] Pub. L. 104–105, 110 Stat. 162 (Feb. 10, 1996).

3. Response to Comments

We acknowledge that the 1996 Act granted Farmer Mac many of the same powers that Fannie Mae and Freddie Mac have to issue and guarantee mortgage securities. These statutory amendments profoundly changed Farmer Mac's business operations and the market for its securities. We agree that the 1996 Act has rendered many provisions of existing § 615.5174 obsolete, and for this reason, this regulation requires more than technical and conforming amendments.

4. Final Regulation

We have fashioned a final regulation that balances the interests of both Farmer Mac and other System institutions. We recognized Farmer Mac's new statutory powers and market realities by repealing all obsolete provisions in § 615.5174. The final regulation responds to Farmer Mac's request for comparable treatment with Fannie Mae and Freddie Mac by applying the investment management provisions of final § 615.5133(b) and (c) and the stress test requirements of final § 615.5141 to Farmer Mac mortgage securities. In the same context, final § 615.5174 focuses on issues that are unique to investments by FCS banks and associations in Farmer Mac mortgage securities. In addition, the final regulation allows System banks and associations more latitude to manage their credit risks through investments in Farmer Mac securities.

Final § 615.5174(a) continues to authorize System banks and associations to invest in mortgage securities that are issued or guaranteed as to principal and interest by Farmer Mac. This provision specifically allows System banks and associations to purchase and hold Farmer Mac securities for the purposes of: (1) Managing credit and interest rate risk; and (2) furthering their mission to finance agriculture. Certain Farmer Mac mortgage securities may help System banks and associations to manage interest rate risk exposures in their portfolios. Additionally, System banks and associations can use these mortgage securities for cashflow management because Farmer Mac guarantees that investors will receive timely payment of principal and interest.

We added explicit references to associations to final § 615.5174 to clarify the scope of this regulation. Because redesignated § 615.5142 contained a redundant authorization for FCS associations to purchase and hold Farmer Mac mortgage securities, we deleted the reference to § 615.5174 in redesignated § 615.5142.

System banks and associations can still acquire subordinated participation interests in Farmer Mac pools, although title VII of the Act no longer requires them to do so. Investments by System banks and associations in subordinate Farmer Mac securities are also subject to regulations in part 614 of this chapter.

In response to Central Coast's request, we modified the portfolio cap in this regulation. Farmer Mac mortgage securities can be used to diversify the credit risk exposure in FCS bank and association agricultural loans and further their important mission objectives. Therefore, final § 615.5174 allows System banks and associations to hold Farmer Mac mortgage securities in an amount that is equal to their total outstanding loans.

We note that System banks must not count Farmer Mac mortgage securities as part of their total outstanding loans when they calculate their 30-percent portfolio limit for liquid investments under § 615.5132. Our reason for this treatment is that Farmer Mac mortgage securities are not considered loans of System banks and associations.

Final § 615.5174(b) covers the responsibilities of boards and senior management for overseeing investments in Farmer Mac securities. This provision requires each Farm Credit bank and association board of directors to adopt written policies that will govern their investments in Farmer Mac securities. Final § 615.5174(b) closely parallels similar provisions in § 615.5133 that guide investment management practices for non-agricultural investments.

Final § 615.5174(c) also closely follows similar provisions in § 615.5133. This provision requires banks and associations to establish policies that identify the types and quantity of Farmer Mac securities they will hold to achieve their objectives and set credit, market, and liquidity risk limits. Under final § 615.5174(c)(2), the board's policy must establish specific criteria for managing credit risk by establishing product and geographic diversification requirements for investments in Farmer Mac mortgage securities. Final § 615.5174(c)(3) requires the board's policies to address how the market risk of Farmer Mac mortgage securities affects the institution's capital and earnings.

Under final § 615.5174(c)(4), board policies must indicate liquidity risk tolerance levels. Risk preferences may be based on the liquidity characteristics of the types of Farmer Mac securities you wish to select for your portfolio and your institutional objectives. We

recognize that if your objective is to hold Farmer Mac securities until maturity, liquidity risk is less important. Additionally, the final regulations prohibit Farm Credit banks from holding Farmer Mac mortgage securities in the liquidity reserve they maintain under § 615.5134. Our concern over concentration risk led us to develop this provision. For example, if the System had real or perceived credit problems due to a crisis in the agricultural economy and could not access the market at reasonable rates, those same economic factors may also adversely affect the price and liquidity of Farmer Mac securities.

Lastly, final § 615.5174(d) requires System banks and associations to perform stress tests in accordance with final § 615.5141 to measure market risks in these securities.

VI. Liquidity Reserve

We received no comment on our proposal to repeal a provision in existing § 615.5134(b) which requires System banks to segregate investments in the liquidity reserve from investments that are held for other purposes under § 615.5132. This amendment provides FCS banks with greater flexibility to decide how to best use their investments to manage risk exposure.

In response to our initiative on regulatory burden, CoBank, ACB, stated that the ''burdensome liquidity reserve requirement calculations should be simplified.'' The commenter did not offer any suggestions for simplifying the liquidity reserve requirement in § 615.5134.

The liquidity reserve requirement for System banks is calculated using a basic formula. The liquidity reserve requirement ensures that FCS banks have a pool of liquid investments to fund their operations for approximately 15 days if their access to the capital markets becomes impeded. We believe the significance of maintaining an ample supply of liquid funds outweighs any burdens created by the liquidity reserve calculation process. Thus, we made no changes to the liquidity reserve calculation at this time.

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 amended to read as follows:

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

1. 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

2. Section 615.5131 is revised to read as follows:

§ 615.5131 Definitions.

For purposes of this subpart, the following definitions apply:

(a) *Asset-backed securities (ABS)* mean investment securities that provide for ownership of a fractional undivided interest or collateral interests in specific assets of a trust that are sold and traded in the capital markets. For the purposes of this subpart, ABS exclude mortgage securities that are defined in § 615.5131(i).

(b) *Bank* means a Farm Credit Bank, agricultural credit bank, or bank for cooperatives.

(c) *Eurodollar time deposit* means a non-negotiable deposit denominated in United States dollars and issued by an overseas branch of a United States bank or by a foreign bank outside the United States.

(d) *Final maturity* means the last date on which the remaining principal amount of a security is due and payable (matures) to the registered owner. It does not mean the call date, the expected average life, the duration, or the weighted average maturity.

(e) *General obligations* of a State or political subdivision means:

(1) The full faith and credit obligations of a State, the District of Columbia, the Commonwealth of Puerto Rico, a territory or possession of the United States, or a political subdivision thereof that possesses general powers of taxation, including property taxation; or

(2) An obligation that is unconditionally guaranteed by an obligor possessing general powers of taxation, including property taxation.

(f) *Liquid investments* are assets that can be promptly converted into cash without significant loss to the investor. 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.

(g) *Loans* are defined by § 621.2(f) of this chapter and they are calculated quarterly (as of the last day of March, June, September, and December) by using the average daily balance of loans during the quarter.

(h) *Market risk* means the risk to the financial condition of your institution because the value of your holdings may decline if interest rates or market prices change. Exposure to market risk is measured by assessing the effect of changing rates and prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution.

(i) *Mortgage securities* means securities that are either:

(1) Pass-through securities or participation certificates that represent ownership of a fractional undivided interest in a specified pool of residential (excluding home equity loans), multifamily or commercial mortgages, or

(2) A multiclass security (including collateralized mortgage obligations and real estate mortgage investment conduits) that is backed by a pool of residential, multifamily or commercial real estate mortgages, pass-through mortgage securities, or other multiclass mortgage securities.

(j) *Nationally Recognized Statistical Rating Organization (NRSRO)* means a rating organization that the Securities and Exchange Commission recognizes as an NRSRO.

(k) *Revenue bond* means an obligation of a municipal government that finances a specific project or enterprise but it is not a full faith and credit obligation. The obligor pays a portion of the revenue generated by the project or enterprise to the bondholders.

(l) *Weighted average life (WAL)* means the average time until the investor receives the principal on a security, weighted by the size of each principal payment and calculated under specified prepayment assumptions.

(m) *You* means a Farm Credit bank, association, or service corporation.

3. Section 615.5133 is revised to read as follows:

§ 615.5133 Investment management.

(a) *Responsibilities of Board of Directors.* Your board must adopt written policies for managing your investment activities. Your board of directors must also ensure that management complies with these policies and that appropriate internal controls are in place to prevent loss. Annually, the board of directors must

review these investment policies and make any changes that are needed.

(b) *Investment policies.* Your board's written investment policies must address the purposes and objectives of investments, risk tolerance, delegations of authority, and reporting requirements. Investment policies must be appropriate for the size, types, and risk characteristics of your investments.

(c) *Risk tolerance.* Your investment policies must establish risk limits and diversification requirements for the various classes of eligible investments and for the entire investment portfolio. These policies must ensure that you maintain appropriate diversification of your investment portfolio. Risk limits must be based on your institutional objectives, capital position, and risk tolerance. Your policies must identify the types and quantity of investments that you will hold to achieve your objectives and control credit, market, liquidity, and operational risks. The policy of any association or service corporation that holds significant investments and each bank must establish risk limits for the following four types of risk.

(1) *Credit risk.* Investment policies must establish:

(i) Credit quality standards, limits on counterparty risk, and risk diversification standards that limit concentrations based on a single or related counterparty(ies), a geographical area, industries or obligations with similar characteristics.

(ii) Criteria for selecting brokers, dealers, and investment bankers (collectively, securities firms). You must buy and sell eligible investments with more than one securities firm. As part of your annual review of your investment policies, your board of directors must review the criteria for selecting securities firms and determine whether to continue your existing relationships with them.

(iii) Collateral margin requirements on repurchase agreements.

(2) *Market risk.* Investment policies must set market risk limits for specific types of investments, the investment portfolio, or your institution. Your board of directors must establish market risk limits in accordance with these regulations and our other policies.

(3) *Liquidity risk.* Investment policies must describe the liquidity characteristics of eligible investments that you will hold to meet your liquidity needs and institutional objectives.

(4) *Operational risk.* Investment policies must address operational risks, including delegations of authority and internal controls in accordance with paragraphs (d) and (e) of this section.

(d) *Delegation of authority.* All delegations of authority to specified personnel or committees must state the extent of management's authority and responsibilities for investments.

(e) *Internal controls.* You must:

(1) Establish appropriate internal controls to detect and prevent loss, fraud, embezzlement, conflicts of interest, and unauthorized investments.

(2) Establish and maintain a separation of duties and supervision between personnel who execute investment transactions and personnel who approve, revaluate, and oversee investments.

(3) Maintain management information systems that are appropriate for the level and complexity of your investment activities.

(f) *Securities valuation.*

(1) Before you purchase a security, you must evaluate its credit quality and its price sensitivity to changes in market interest rates. You must also verify the value of a security that you plan to purchase, other than a new issue, with a source that is independent of the broker, dealer, counterparty or other intermediary to the transaction.

(2) You must determine the fair market value of each security in your portfolio and the fair market value of your whole investment portfolio at least monthly. You must also evaluate the credit quality and price sensitivity to change in market interest rates of all investments that you hold on an ongoing basis.

(3) Before you sell a security, you must verify its value with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction.

(g) *Reports to the board.* Each quarter, management must report to the board of directors or a board committee on the performance and risk of each class of investments and the entire investment portfolio. These reports must identify all gains and losses that you incur during the quarter on individual securities that you sold before maturity. Reports must also identify potential risk exposure to changes in market interest rates and other factors that may affect the value of your bank's investment holdings. Management's report must discuss how investments affect your bank's overall financial condition and must evaluate whether the performance of the investment portfolio effectively achieves the board's objectives. Any deviations from the board's policies must be specifically identified in the report.

4. Section 615.5134 is amended by revising paragraph (b) to read as follows:

§ 615.5134 Liquidity reserve requirement.

* * * * *

(b) All investments that the bank holds for the purpose of meeting the liquidity reserve requirement of this section must be free of lien.

* * * * *

5. Section 615.5140 is revised to read as follows:

§ 615.5140 Eligible investments.

(a) You may hold only the following types of investments listed in the Investment Eligibility Criteria Table. These investments must be denominated in United States dollars.

Billing Code 6705–01–P

Investment Eligibility Criteria Table

ASSET CLASS	FINAL MATURITY LIMIT	NRSRO CREDIT RATING	OTHER REQUIREMENTS	INVESTMENT PORTFOLIO LIMIT
(1) Obligations of the United States • Treasuries • Agency securities (except mortgage securities) • Other obligations fully insured or guaranteed by the United States, its agencies, instrumentalities and corporations	None	NA	None	None
(2) Municipal Securities				
• General obligations	10 years	One of the highest two	None	None
• Revenue bonds	5 years	Highest	At the time of purchase, you must document that the issue is actively traded in an established secondary market	15%
(3) International and Multilateral Development Bank Obligations	None	None	The United States must be a voting shareholder	None
(4) Money Market Instruments				
• Federal funds	1 day or continuously callable up to 100 days	One of the two highest short-term	None	None
• Negotiable certificates of deposit	1 year		None	None
• Bankers acceptances	None		Issued by a depository institution	None
• Commercial paper	270 days	Highest short-term	None	None
• Non-callable Term Federal funds and Eurodollar time deposits	100 days			20%
• Master notes	270 days			20%
• Repurchase agreements collateralized by eligible investments or marketable securities rated in the highest credit rating category by an NRSRO	100 days	NA	If counterparty defaults, you must divest non-eligible securities under § 615.5143	None

ASSET CLASS	FINAL MATURITY LIMIT	NRSRO CREDIT RATING	OTHER REQUIREMENTS	INVESTMENT PORTFOLIO LIMIT
(5) Mortgage Securities				
• Issued or guaranteed by the United States	None	NA	Stress testing under § 615.5141	None
• Fannie Mae or Freddie Mac mortgage securities	None	NA	Stress testing under § 615.5141	50%
• Non-Agency securities that comply 15 U.S.C. 77d(5) or 15 U.S.C. 78c(a)(41)	None	Highest	Stress testing under § 615.5141	15%
• Commercial mortgage-backed securities	None	Highest	• Security must be backed by a minimum of 100 loans. • Loans from a single mortgagor cannot exceed 5% of the pool • Pool must be geographically diversified pursuant to the board's policy • Stress testing under § 615.5141	
(6) Asset-Backed Securities secured by: • Credit card receivables • Automobile loans • Home equity loans • Wholesale automobile dealer loans • Student loans • Equipment loans • Manufactured housing loans	None	Highest	5-year WAL for fixed rate or floating rate ABS at their contractual interest rate caps 7-year WAL for floating rate ABS that remain below their contractual interest rate cap	20%
(7) Corporate Debt Securities	5 years	One of the two highest	Cannot be convertible to equity securities	20%
(8) Diversified Investment Funds Shares of an investment company registered under section 8 of the Investment Company Act of 1940	NA	NA	The portfolio of the investment company must consist solely of eligible investments authorized by §§ 615.5140 and 615.5174. The investment company's risk and return objectives and use of derivatives must be consistent with FCA guidance and your investment policies.	None, if your shares in each investment company comprise 10% or less of your portfolio. Otherwise counts toward limit for each type of investment.

BILLING CODE 6705-01-C

(b) *Rating of foreign countries.* Whenever the obligor or issuer of an eligible investment is located outside the United States, the host country must maintain the highest sovereign rating for political and economic stability by an NRSRO.

(c) *Marketable securities.* All eligible investments, except money market instruments, must be marketable. An eligible investment is marketable if you can sell it quickly at a price that closely reflects its fair value in an active and universally recognized secondary market.

(d) *Obligor limits.*

(1) You may not invest more than 20 percent of your total capital in eligible investments issued by any single institution, issuer, or obligor. This obligor limit does not apply to obligations, including mortgage securities, that are issued or guaranteed as to interest and principal by the United States, its agencies, instrumentalities, or corporations.

(2) Obligor limits for your holdings in an investment company You must count securities that you hold through an investment company towards the obligor limit of this section unless the investment company's holdings of the security of any one issuer do not exceed five (5) percent of the investment company's total portfolio.

(e) *Other investments approved by the FCA.* You may purchase and hold other investments that we approve. Your request for our approval must explain the risk characteristics of the investment and your purpose and objectives for making the investment.

§§ 615.5141 through 615.5143 [Redesignated]

6. Sections 615.5141, 615.5142, and 615.5143 are redesignated as §§ 615.5142, 615.5143, and 615.5144, respectively, and a new § 615.5141 is added to read as follows:

§ 615.5141 Stress tests for mortgage securities.

Mortgage securities are not eligible investments unless they pass a stress test. You must perform stress tests to determine how interest rate changes will affect the cashflow and price of each mortgage security that you purchase and hold, except for adjustable rate securities that reprice at intervals of 12 months or less and are tied to an index. You must also use stress tests to gauge how interest rate fluctuations on mortgage securities affect your institution's capital and earnings. You may conduct the stress tests as described in either paragraph (a) or (b) of this section.

(a) Mortgage securities must comply with the following three tests at the time of purchase and each following quarter:

(1) *Average Life Test.* The expected WAL of the instrument does not exceed 5 years.

(2) *Average Life Sensitivity Test.* The expected WAL does not extend for more than 2 years, assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points, nor shorten for more than 3 years, assuming an immediate and sustained parallel shift in the yield curve of minus 300 basis points.

(3) *Price Sensitivity Test.* The estimated change in price is not more than thirteen (13) percent due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

(4) *Exemption.* A floating rate mortgage security is subject only to the price sensitivity test in paragraph (a)(3) of this section if at the time of purchase and each quarter thereafter it bears a rate of interest that is below its contractual cap.

(b) You may use an alternative stress test to evaluate the price sensitivity of your mortgage securities. An alternative stress test must be able to measure the price sensitivity of mortgage instruments over different interest rate/yield curve scenarios. The methodology that you use to analyze mortgage securities must be appropriate for the complexity of the instrument's structure and cashflows. Prior to purchase and each quarter thereafter, you must use the stress test to determine that the risk in the mortgage security is within the risk limits of your board's investment policies. The stress test must enable you to determine at the time of purchase and each subsequent quarter that the mortgage security does not expose your capital or earnings to excessive risks.

(c) You must rely on verifiable information to support all your assumptions, including prepayment and interest rate volatility assumptions, when you apply the stress tests in either paragraph (a) or (b) of this section. You must document the basis for all assumptions that you use to evaluate the security and its underlying mortgages. You must also document all subsequent changes in your assumptions. If at any time after purchase, a mortgage security no longer complies with requirements in this section, you must divest it in accordance with § 615.5143.

7. Newly designated § 615.5142 is revised to read as follows:

§ 615.5142 Association investments.

An association may hold eligible investments listed in § 615.5140, with the approval of its funding bank, for the purposes of reducing interest rate risk and managing surplus short-term funds. Each bank must review annually the investment portfolio of every association that it funds.

8. Newly designated § 615.5143 is revised to read as follows:

§ 615.5143 Disposal of ineligible investments.

You must dispose of an ineligible investment within 6 months unless we approve, in writing, a plan that authorizes you to divest the instrument over a longer period of time. An acceptable divestiture plan must require you to dispose of the ineligible investment as quickly as possible without substantial financial loss. Until you actually dispose of the ineligible investment, the managers of your investment portfolio must report at least quarterly to your board of directors about the status and performance of the ineligible instrument, the reasons why it remains ineligible, and the managers' progress in disposing of the investment.

Subpart F—Property and Other Investments

9. Section 615.5174 is revised to read as follows:

§ 615.5174 Farmer Mac securities.

(a) *General authority.* You may purchase and hold mortgage securities that are issued or guaranteed as to both principal and interest by the Federal Agricultural Mortgage Corporation (Farmer Mac securities). You may purchase and hold Farmer Mac securities for the purposes of managing credit and interest rate risks, and furthering your mission to finance agriculture. The total value of your Farmer Mac securities cannot exceed your total outstanding loans, as defined by § 615.5131(g).

(b) *Board and management responsibilities.* Your board of directors must adopt written policies that will govern your investments in Farmer Mac securities. All delegations of authority to specified personnel or committees must state the extent of management's authority and responsibilities for managing your investments in Farmer Mac securities. The board of directors must also ensure that appropriate internal controls are in place to prevent loss, in accordance with § 615.5133(e). Management must submit quarterly reports to the board of directors on the performance of all investments in Farmer Mac securities. Annually, your board of directors must review these policies and the performance of your

Farmer Mac securities and make any changes that are needed.

(c) *Policies.* Your board of directors must establish investment policies for Farmer Mac securities that include your:

(1) *Objectives* for holding Farmer Mac securities.

(2) *Credit risk* parameters including:

(i) The quantities and types of Farmer Mac mortgage securities that are collateralized by qualified agricultural mortgages, rural home loans, and loans guaranteed by the Farm Service Agency.

(ii) Product and geographic diversification for the loans that underlie the security; and

(iii) Minimum pool size, minimum number of loans in each pool, and maximum allowable premiums or discounts on these securities.

(3) *Liquidity risk* tolerance and the liquidity characteristics of Farmer Mac securities that are suitable to meet your institutional objectives. A bank may not include Farmer Mac mortgage securities in the liquidity reserve maintained to comply with § 615.5134.

(4) *Market risk* limits based on the effects that the Farmer Mac securities have on your capital and earnings.

(d) *Stress Test.* You must perform stress tests on mortgage securities that are issued or guaranteed by Farmer Mac in accordance with the requirements of § 615.5141(b) and (c). If a Farmer Mac security fails a stress test, you must divest it as required by § 615.5143.

Dated: May 13, 1999.

Vivian Portis,

Secretary, Farm Credit Administration Board.

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DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 33

[Docket No. NE121; Special Conditions No. 33–002–SC]

Special Conditions: General Electric Aircraft Engines Models CT7–6D, CT7–6E and CT7–8 Turboshaft Engines.

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final special conditions; request for comments.

SUMMARY: These special conditions are issued for the General Electric Aircraft Engines (GEAE) Models CT7–6D, CT7–6E and CT7–8 turboshaft engines. These engines will have 30-second one-engine-inoperative (OEI) and 2-minute OEI ratings. The applicable airworthiness standards do not contain appropriate safety standards for engine overspeed test requirements for these engine ratings. This document contains the additional safety standards for the overspeed test for these ratings under § 33.27 that the Administrator considers necessary to establish a level of safety equivalent to that established by the existing airworthiness standards. This document also specifies the mandatory post-flight engine inspection and maintenance requirements for these ratings in accordance with § 33.4.

DATES: The effective date of these special conditions is May 21, 1999. Comments must be received on or before July 27, 1999.

ADDRESSES: Comments on these special conditions may be mailed in duplicate to: Federal Aviation Administration, Office of the Regional Counsel, Attention: Docket NE121; 12 New England Executive Park, Burlington, Massachusetts 01803–5299, or delivered in duplicate to the Office of the Regional Counsel at the above address. Comments must be marked: Docket No. NE121. Comments may be inspected in the Docket weekdays, except Federal holidays, between 8:00 a.m. and 4:30 p.m.

FOR FURTHER INFORMATION CONTACT: Chung Hsieh, FAA, Engine and Propeller Standards Staff, ANE–110, Engine and Propeller Directorate, Aircraft Certification Service, 12 New England Executive Park, Burlington, Massachusetts 01803–5299; telephone (781) 238–7115; facsimile (781) 238–7199.

SUPPLEMENTARY INFORMATION:

Comments Invited

The FAA has determined that good cause exists for making these special conditions effective upon issuance; however, interested persons are invited to submit such written data, views, or arguments as they may desire. Communications should identify the docket and special conditions numbers and be submitted in duplicate to the address specified above. All communications received on or before the closing date for comments will be considered by the Administrator. These special conditions may be changed in light of the comments received. All comments submitted will be available in the Docket for examination by interested persons, both before and after the closing date for comments. A report summarizing each substantive public contact with FAA personnel concerning this rulemaking will be filed in the docket. Persons wishing the FAA to acknowledge receipt of their comments submitted in response to this request must submit with those comments a self-addressed, stamped postcard on which the following statement is made: ''Comments to Docket No. NE121.'' The postcard will be date-stamped and returned to the commenter.

Background

On May 24, 1996, GEAE applied for an amendment to type certificate E8NE to include a new model CT7–6E turboshaft engine. On July 15, 1996, GEAE applied for an amendment to type certificate E8NE to include a new model CT7–6D turboshaft engine. On August 12, 1996, GEAE applied for an amendment to type certificate E8NE to include a new model CT7–8 turboshaft engine. These models are all derivatives of the CT7 series turboshaft engine. With all of these applications GEAE applied for 30-second OEI and 2-minute OEI ratings for the new engine designs. The CT7–6D and the CT7–6E turboshaft engines will be rated at 30-second OEI, 2-minute OEI, continuous OEI, takeoff, and maximum continuous ratings. The CT7–8 turboshaft engine will be rated at 30-second OEI, 2-minute OEI, 30-minute OEI, takeoff, and maximum continuous ratings.

On June 19, 1996, the FAA published a final rule setting airworthiness standards for 30-second and 2-minute OEI engine ratings (61 FR 31324). Prior to that rule the airworthiness standards for engines, 14 CFR part 33, did not contain appropriate safety standards for engine overspeed test requirements for 30-second and 2-minute OEI engine ratings. Engine manufacturers who had applied for type certificates for engine designs that contained 30-second and 2-minute OEI ratings were issued special conditions to address, among other things, engine overspeed test requirements for those ratings, which were considered at the time to be novel and unusual engine ratings. The final rule, however, did not contain the proposed revisions to the airworthiness standards on engine overspeed test for these OEI ratings under § 33.27 that appeared in both the Notice of Proposed Rulemaking (NPRM) No. 89–27, published on September 22, 1989 (54 FR 39080), and the Supplemental Notice of Proposed Rulemaking (SNPRM) No. 89–27A (60 FR 7380), published on February 7, 1995. The FAA elected to drop the proposed changes to § 33.27 from the final rule in response to commenters who noted that the proposed revisions were not consistent with the status of the discussions on OEI test requirements ongoing at the time by a working group of the Aviation Rulemaking Advisory Committee