

# Proposed Rules

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

## FARM CREDIT ADMINISTRATION

### 12 CFR Part 615

RIN 3052-AC25

#### Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Capital Adequacy—Basel Accord

**AGENCY:** Farm Credit Administration.

**ACTION:** Advance notice of proposed rulemaking (ANPRM).

**SUMMARY:** The Farm Credit Administration (FCA or we) is considering possible modifications to our risk-based capital rules for Farm Credit System institutions (FCS or System) that are similar to the standardized approach delineated in the New Basel Capital Accord. We are seeking comments to facilitate the development of a proposed rule that would enhance our regulatory capital framework and more closely align minimum capital requirements with risks taken by System institutions. We are also withdrawing our previously published ANPRM.

**DATES:** You may send comments on or before March 31, 2008.

**ADDRESSES:** We offer several methods for the public to submit comments. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the Agency's Web site or the Federal eRulemaking Portal. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

- *E-mail:* Send us an e-mail at [reg-comm@fca.gov](mailto:reg-comm@fca.gov).
- *Agency Web site:* <http://www.fca.gov>. Select "Legal Info," then "Pending Regulations and Notices."
- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.
- *Mail:* Gary K. Van Meter, Deputy Director, Office of Regulatory Policy,

Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

• *Fax:* (703) 883-4477. Posting and processing of faxes may be delayed, as faxes are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act. Please consider another means to comment, if possible.

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

#### FOR FURTHER INFORMATION CONTACT:

Laurie Rea, Associate Director, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4232, TTY (703) 883-4434, or Wade Wynn, Policy Analyst, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4262, TTY (703) 883-4434, or Rebecca S. Orlich, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TTY (703) 883-4020.

#### SUPPLEMENTARY INFORMATION:

##### I. Objectives

The objective of this ANPRM is to gather information to facilitate the development of a comprehensive proposal that would:

1. Promote safe and sound banking practices and a prudent level of regulatory capital for System institutions;<sup>1</sup>
2. Improve the risk sensitivity of our regulatory capital requirements while avoiding undue regulatory burden;

<sup>1</sup> The System was created by Congress in 1916 and is the oldest GSE in the United States. System institutions provide credit and financially related services to farmers, ranchers, producers or harvesters of aquatic products, and farmer-owned cooperatives. They also make credit available for agricultural processing and marketing activities, rural housing, certain farm-related businesses, agricultural and aquatic cooperatives, rural utilities, and foreign and domestic entities in connection with international agricultural trade.

3. To the extent appropriate, minimize differences in regulatory capital requirements between System institutions and federally regulated banking organizations;<sup>2</sup> and

4. Foster economic growth in agriculture and rural America through the effective allocation of System capital.

In addition, we are withdrawing our previous ANPRM on capital, published in the **Federal Register** on June 21, 2007 (72 FR 34191), as described more fully below.

## II. Background

The FCA's risk-based capital requirements for System institutions are contained in subparts H and K of part 615 of our regulations.<sup>3</sup> Our risk-based capital framework is based, in part, on the "International Convergence of Capital Measurement and Capital Standards" (Basel I) as published by the Basel Committee on Banking Supervision (Basel Committee)<sup>4</sup> and is broadly consistent with the capital requirements of the other Federal financial regulatory agencies.<sup>5</sup> We first adopted a risk-based capital framework for the System as part of our 1988 regulatory capital revisions<sup>6</sup> required by the Agricultural Credit Act of 1987<sup>7</sup> and made subsequent revisions in 1997,<sup>8</sup> 1998<sup>9</sup> and 2005.<sup>10</sup> Under the current capital framework, each on- and off-balance sheet credit exposure is assigned to one of five broad risk-weighting categories to determine the

<sup>2</sup> Banking organizations include commercial banks, savings associations, and their respective bank holding companies.

<sup>3</sup> Our regulations can be accessed at <http://www.fca.gov/index.html>.

<sup>4</sup> The Basel Committee on Banking Supervision was established in 1974 by central banks with bank supervisory authorities in major industrialized countries. The Basel Committee formulates standards and guidelines related to banking and recommends them for adoption by member countries and others. All Basel Committee documents are available at <http://www.bis.org>.

<sup>5</sup> We refer collectively to the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision as the "other Federal financial regulatory agencies."

<sup>6</sup> See 53 FR 39229 (October 6, 1988).

<sup>7</sup> Pub. L. 100-233 (January 6, 1988), section 301. The 1987 Act amended many provisions of the Farm Credit Act of 1971, as amended, which is codified at 12 U.S.C. 2001 *et seq.*

<sup>8</sup> See 62 FR 4429 (January 30, 1997).

<sup>9</sup> See 63 FR 39219 (July 22, 1998).

<sup>10</sup> See 70 FR 35336 (June 17, 2005).

risk-adjusted asset base, which is the denominator for computing the permanent capital, total surplus, and core surplus ratios.

For a number of years, the Basel Committee has worked to develop a more risk sensitive regulatory capital framework that incorporates recent innovations in the financial services industry. In June 2004, it published the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Basel II) to promote improved risk measurement and management processes and more closely align capital requirements with risk.<sup>11</sup> Basel II has three pillars: (1) Minimum capital requirements for credit risk, operational risk, and market risk, (2) supervision of capital adequacy, and (3) market discipline through enhanced public disclosure. Banking organizations have various options for calculating the minimum capital requirements for credit and operational risk. For credit risk, the options are the standardized approach, the foundation internal ratings-based approach, and the advanced internal ratings-based approach (A-IRB). For operational risk, the options are the basic indicator approach, the standardized approach, and the advanced measurement approach (AMA).

In September 2006, the other Federal financial regulatory agencies issued an interagency notice of proposed rulemaking for implementing the advanced approaches of Basel II in the United States (the advanced capital framework).<sup>12</sup> This advanced capital framework would require core banks<sup>13</sup> and permit opt-in banks<sup>14</sup> to use the A-IRB<sup>15</sup> to calculate the regulatory capital requirement for credit risk and the AMA<sup>16</sup> to calculate the regulatory

capital requirement for operational risk.<sup>17</sup>

Given the small number of core banks and the complexity and cost associated with voluntarily adopting the advanced approaches, only a small number of U.S. banking organizations are expected to implement the advanced capital framework. As a result, a bifurcated regulatory capital framework will be created in the United States, which could result in different regulatory capital charges for similar products offered by those that apply the advanced capital framework and those that do not. Financial regulators, banking organizations, trade associations and other interested parties have raised concerns that the bifurcated structure could create a significant competitive disadvantage for those that do not apply the advanced capital framework.

In December 2006, the other Federal financial regulatory agencies addressed these concerns by issuing an interagency notice of proposed rulemaking (Basel IA) to improve the risk sensitivity of the existing Basel I-based capital framework.<sup>18</sup> Subsequently, the FCA issued an ANPRM,<sup>19</sup> published in June 2007, addressing issues similar to those addressed in Basel IA. Basel IA was intended to help minimize the potential differences in the regulatory minimum capital requirements of those banks applying the advanced capital framework and those banks that would not. The other Federal financial regulatory agencies received a significant number of comments opposing their Basel IA proposal. Many commenters argued that the benefits of complying with Basel IA did not outweigh the burdens, and many questioned why the U.S. banking agencies were creating a separate rule that had only minor differences from the standardized approach under Basel II. On July 20, 2007, the other Federal financial regulatory agencies announced that they intended to replace the Basel IA proposal with a proposed rule that would provide all non-core banks the option to adopt the standardized approach under Basel II.<sup>20</sup> Their stated intent is to finalize a standardized approach for banks that do not adopt the

advanced approaches before the core (and opt-in) banks begin their first transition period year under the advanced approaches of Basel II.

The other Federal financial regulatory agencies plan to replace Basel IA with a proposed rule patterned after the standardized approach under Basel II. Consequently, we are withdrawing our previous ANPRM and replacing it with one that is also consistent with the standardized approach. We intend to develop a proposed rule that is similar to the capital requirements of the other Federal financial regulatory agencies where appropriate but also tailored to fit the System's distinct borrower-owned lending cooperative structure and Government-sponsored enterprise (GSE) mission.

The questions posed in this ANPRM are, for the most part, similar to the questions we asked in our previous ANPRM.<sup>21</sup> We have revised the technical material in most places to conform to the standardized approach of Basel II. For example, we replaced the risk-weight categories that were in the Basel IA proposed rule with the risk-weight categories that are contained in the standardized approach under Basel II. We ask commenters to consider the revised material when answering the following questions. We seek comments from all interested parties to help us develop a comprehensive proposal that would enhance our regulatory capital framework and increase the risk sensitivity of our risk-based capital rules without unduly increasing regulatory burden.

### III. Questions

When addressing the following questions, we ask commenters to consider the overarching objectives of Basel II to more closely align capital with the specific risks taken by the financial institution rather than relying on a "one-size-fits-all" approach for determining regulatory minimum risk-based capital requirements. Our objective is to develop a more dynamic risk-based capital framework that is more sensitive to the relative risks inherent in System lending and other mission-related activities. We seek comments on specific criteria that might be used to determine appropriate risk weights that meet this objective without

<sup>11</sup> See <http://www.bis.org/publ/bcbcsa.htm> for the 2004 Basel II Accord as well as updates in 2005 and 2006.

<sup>12</sup> See 71 FR 55830 (September 25, 2006). This document is at <http://www.federalreserve.gov/generalinfo/basel2/USImplementation.htm>.

<sup>13</sup> Core banks are banking organizations that have consolidated total assets of \$250 billion or more or have consolidated on-balance sheet foreign exposures of \$10 billion or more.

<sup>14</sup> Opt-in banks are banking organizations that do not meet the definition of a core bank but have the risk management and measurement capabilities to voluntarily implement the advanced approaches of Basel II with supervisory approval.

<sup>15</sup> A banking organization computes internal estimates of certain key risk parameters for each credit exposure or pool of exposures and feeds the results into regulatory formulas to determine the risk-based capital requirement for credit risk.

<sup>16</sup> Internal operational risk management systems and processes are used to compute risk-based capital requirements for operational risk.

<sup>17</sup> The other Federal financial regulatory agencies also seek comments on whether core and opt-in banks should be permitted to use other credit and operational risk approaches.

<sup>18</sup> 71 FR 77446 (December 26, 2006). This document is at <http://www.federalreserve.gov/generalinfo/basel2/USImplementation.htm>.

<sup>19</sup> 72 FR 34191 (June 21, 2007).

<sup>20</sup> Joint Press Release, "Banking Agencies Reach Agreement On Basel II Implementation," (July 20, 2007). This document is at <http://www.occ.gov/ftp/release/2007-77.htm>.

<sup>21</sup> Questions 1, 3, 4, 5, 9 and 10 in this ANPRM are identical to those numbered questions posed in our previous ANPRM. Questions 2, 6 and 11 are slightly different. Question 7 in this ANPRM replaces Questions 7 and 8 in our previous ANPRM. Questions 8, 12, and 16 are new to this ANPRM. Questions 13 through 15 are identical to Questions 12 through 14 in our previous ANPRM. Question 17 is identical to Question 15 in our previous ANPRM.

creating undue burden. Specifically, we ask that you support your comments with data, to the extent possible, in response to our questions.<sup>22</sup>

#### A. Increase the Number of Risk-Weight Categories

Our existing risk-based capital rules assign exposures to one of five risk-weight categories: 0, 20, 50, 100, and 200 percent.<sup>23</sup> The standardized approach of Basel II adds risk-weight categories of 35, 75, and 150 percent and replaces the 200-percent risk-weight category with a 350-percent risk-weight category.<sup>24</sup> The 35-percent risk-weight category would apply to certain residential mortgages. The 75-percent risk-weight category would apply to certain retail claims (e.g., small business loans). The 150-percent and 350-percent risk-weight categories would apply to certain higher risk externally rated

exposures (e.g., those below investment grade).

*Question 1: We seek comment on what additional risk-weight categories, if any, we should consider for assigning risk weights to System institutions' on- and off-balance sheet exposures. If additional risk-weight categories are added, what assets should be included in each new risk-weight category?*

#### B. Use of External Credit Ratings To Assign Risk-Weight Exposures

##### 1. Direct Exposures

In recent years, the FCA has permitted System institutions to use external ratings to assign risk weights to certain credit exposures linked to nationally recognized statistical rating organizations (NRSROs) ratings.<sup>25</sup> For example, in March 2003, we adopted an interim final rule that permitted System institutions to use NRSRO ratings to place highly rated investments in non-

agency asset-backed securities (ABS) and mortgage-backed securities (MBS) in the 20-percent risk-weight category.<sup>26</sup> In April 2004, we expanded the use of NRSRO ratings to assign risk weights to loans to other financing institutions.<sup>27</sup> In June 2005, we adopted a ratings-based approach to assign risk weights to recourse obligations, direct credit substitutes (DCS), residual interests (other than credit-enhancing interest-only strips), and other ABS and MBS investments.<sup>28</sup> Furthermore, we recently permitted the use of NRSRO ratings to assign risk weights to certain electric cooperative credit exposures.<sup>29</sup>

The standardized approach of Basel II expands the use of NRSRO ratings to determine the risk-based capital charge for long-term exposures to sovereign entities, non-central government public sector entities (PSEs), banks,<sup>30</sup> corporate entities, and securitizations as displayed in Table 1 set forth below.<sup>31</sup>

TABLE 1.—THE STANDARDIZED APPROACH RISK WEIGHTS BASED ON EXTERNAL RATINGS FOR LONG-TERM EXPOSURES

Credit assessment	Sovereign risk weight (in percent)	PSE and bank* risk weights (in percent)		Corporate risk weight (in percent)	Securitization** risk weight (in percent)
		Option 1	Option 2		
AAA to AA—	0	20	20	20	20.
A+ to A—	20	50	50	50	50.
BBB+ to BBB—	50	100	50	100	100.
BB+ to BB—	100	100	100	100	350.
B+ to B—	100	100	100	150	Deduction.***
Below B—	150	150	150	150	Deduction.***
Unrated	100	100	50	100	Deduction.***

\* The Standardized Approach provides two options for PSEs and bank exposures: (1) Option 1 assigns a risk weight one category below that of sovereigns; (2) Option 2 assigns a risk weight based on the individual bank rating. Option 2 also provides risk weights for short-term claims as follows: (1) AAA to BBB— and unrated = 20 percent; (2) BB+ to B— = 50 percent; and (3) Below B— = 150 percent.

\*\* Short-term rating categories are as follows: (1) A–1/P–1 = 20 percent; (2) A–2/P–2 = 50 percent; (3) A–3/P–3 = 100 percent; and (4) All other ratings or unrated = Deduction.

\*\*\* Banks must deduct the entire amount from capital. However, if banks originate a securitization and the most senior exposure is unrated, the bank may use the “look through” treatment, which is the average risk weight of the underlying exposures subject to supervisory review.

System institutions provide financing to agriculture and rural America through a variety of lending<sup>32</sup> and investment<sup>33</sup> products. They also hold highly rated liquid investments to manage liquidity, short-term surplus funds, and interest rate risk. Our

existing risk-based capital rules assign most agricultural and rural business<sup>34</sup> loans and mission-related investment assets to the 100-percent risk-weight category unless the risk exposure is mitigated by an acceptable guarantee or collateral. The FCA is considering the

expanded use of NRSRO ratings to assign risk weights to other externally rated credit exposures in the System, such as corporate debt securities and loans.

*Question 2: We seek comments on all aspects of the appropriateness of using NRSRO ratings to assign risk weights to*

<sup>22</sup> Please note that any data you submit will be made available to the public in our rulemaking file.

<sup>23</sup> FCA's risk-weight categories are set forth in 12 CFR 615.5211.

<sup>24</sup> Basel IA proposed adding risk-weight categories of 35, 75, and 150 percent.

<sup>25</sup> A NRSRO is a credit rating organization that is recognized by and registered with the Securities and Exchange Commission (SEC) as a nationally recognized statistical rating organization. See 12 CFR 615.5201. See also Pub. L. 109–291.

<sup>26</sup> See 68 FR 15045 (March 28, 2003).

<sup>27</sup> Other financing institutions are non-System financial institutions that borrow from System banks. See 69 FR 29852 (May 26, 2004).

<sup>28</sup> These changes are consistent with those of the other Federal financial regulatory agencies. See 70 FR 35336 (June 17, 2005).

<sup>29</sup> See “Revised Regulatory Capital Treatment for Certain Electric Cooperatives Assets,” FCA Booklet BL–053 (February 12, 2007).

<sup>30</sup> Banks include multilateral development banks and securities firms.

<sup>31</sup> Basel IA proposed the categories sovereign entities, non-sovereign entities, and securitizations with different risk-weight categories.

<sup>32</sup> The Farm Credit Banks provide wholesale funding to their affiliated associations who, in turn, make retail loans to eligible borrowers. CoBank, ACB, provides both wholesale funding to its

affiliated associations and retail loans to cooperatives and other eligible borrowers.

<sup>33</sup> System banks and associations are permitted to make mission-related investments to agriculture and rural America. See “Investments in Rural America-Pilot Investment Programs,” FCA Informational Memorandum (January 11, 2005).

<sup>34</sup> Agricultural businesses include farmer-owned cooperatives, food and fiber processors and marketers, manufacturers and distributors of agricultural inputs and services, and other agricultural-related businesses. Rural businesses include electric utilities and other energy-related businesses, communication companies, water and waste disposal businesses, ethanol plants, and other rural-related businesses.

*credit exposures. If we expand the use of external ratings, how should we align the risk-weight categories with NRSRO ratings to determine the appropriate capital charge for externally rated credit exposures? Should any externally rated positions be excluded from this new ratings-based approach? We ask commenters to consider the substantial reliance on NRSRO ratings as a means of evaluating the quality of debt investments in view of recent events in the subprime mortgage market.*

## 2. Recognized Financial Collateral

Our current risk-based capital rules assign lower risk weights to exposures collateralized by: (1) Cash held by a System institution or its funding bank; (2) securities issued or guaranteed by the U.S. Government, its agencies or Government-sponsored agencies; (3)

securities issued or guaranteed by central governments in other OECD<sup>35</sup> countries; (4) securities issued by certain multilateral lending or regional development institutions; or (5) securities issued by qualifying securities firms.

The standardized approach of Basel II has two methods for recognizing a wider variety of collateral types for risk-weighting purposes.<sup>36</sup> Under the simple approach, the collateralized portion of the exposure would be assigned a risk weight (as listed in Table 1) according to the external rating of the collateral. The remainder of the exposure would be assigned a risk weight appropriate to the counterparty. Collateral would be subject to a 20-percent floor unless the collateral is cash, certain government securities or repurchase agreements, and

it would be marked-to-market and revalued every 6 months. Securities issued by sovereigns or PSEs must be rated at least BB-or its equivalent by a NRSRO. Securities issued by other entities must be rated at least BBB-or its equivalent by an NRSRO. Short-term debt instruments used as collateral must be rated at least A-3/P-3 or its equivalent by an NRSRO.

Under the comprehensive approach, the banking organization adjusts the value of the exposure by the discounted value of the collateral. Discount values, known as supervisory haircuts, are displayed in Table 2 set forth below. For example, sovereign debt rated A+ with a 5-year maturity used as collateral is discounted by 3 percent, and corporate debt rated A+ with a 5-year maturity is discounted at 6 percent.

TABLE 2.—STANDARD SUPERVISORY HAIRCUTS IN THE COMPREHENSIVE APPROACH FOR CREDIT MITIGATION

Issue rating for debt securities	Residual maturity	Sovereigns and PSEs* (in percent)	Other issuers** (in percent)
AAA to AA – or A –	≤ 1 year	0.5	1
	> 1 year, ≤ 5 years	2	4
	> 5 years	4	8
A+ to BBB – or A-2/A-3/P-3	≤ 1 year	1	2
	> 1 year, ≤ 5 years	3	6
	> 5 years	6	12
BB+ to BB –	All	15	

\* Includes PSEs treated as sovereigns.

\*\* Includes PSEs not treated as sovereigns.

*Question 3: We seek comment on whether recognizing additional types of eligible collateral would improve the risk sensitivity of our risk-based capital rules without being overly burdensome. We also seek comment on what additional types of collateral, if any, we should consider and what effect the collateral should have on the risk weighting of System exposures.*

## 3. Eligible Guarantors

Our existing capital rules permit the use of third party guarantees to lower the risk weight of certain exposures. Guarantors include: (1) The U.S. Government, its agencies or Government-sponsored agencies; (2) U.S. state and local governments; (3) central governments and banks in OECD countries; (4) central governments in non-OECD countries (local currency exposures only); (5) banks in non-OECD

countries (short-term claims only); (6) certain multilateral lending and regional development institutions; and (7) qualifying securities firms.

The standardized approach of Basel II expands the range of eligible guarantors to include sovereign entities, PSEs, banks and securities firms that have a lower risk weight than the counterparty.<sup>37</sup> All other guarantors must be rated A – (or its equivalent) or better by a NRSRO. The guarantee must: (1) Represent a direct claim on the protection provider, (2) be explicitly referenced to specific exposures or pools of exposures, (3) be irrevocable, and (4) unconditional. The guarantor's risk weight would be substituted for the risk weight assigned to the exposure. Non-guaranteed portions of the exposure would be assigned to the external rating of the exposure.

*Question 4: We seek comment on what additional types of third party guarantees, if any, we should recognize and what effect such guarantees should have on the risk weighting of System exposures.*

## C. Direct Loans to System Associations

The FCA is considering ways to better align our risk-based capital requirements for direct loans with System associations. System banks make direct loans to their affiliated associations who, in turn, make retail loans to eligible borrowers. Our current risk-based capital rules assign a 20-percent risk weight to direct loans at the bank level and another risk weight (depending upon the type of loan) to retail loans at the association level.<sup>38</sup> The 20-percent risk weight is intended to recognize the risks to the banks associated with lending to their

<sup>35</sup> OECD stands for the Organization for Economic Cooperation and Development. The OECD is an international organization of countries that are committed to democratic government and the market economy. An up-to-date listing of member countries is available at <http://www.oecd.org> or <http://www.oecdwash.org>.

<sup>36</sup> Basel IA proposed assigning lower risk weights to exposures collateralized by securities issued by sovereigns or non-sovereigns that were externally rated at least investment grade.

<sup>37</sup> Basel IA proposed to include guarantees from any entity that had long-term senior debt rated at

least investment grade (or issuer rating if a sovereign).

<sup>38</sup> Our risk-based capital rules also assign a 20-percent risk weight to similar GSE and OECD depository institution exposures.

affiliated associations. We are exploring methods to improve the risk sensitivity of our risk-based capital rules by assigning different risk weights to direct loan exposures based on the System association's distinct risk profile.

*Question 5: We seek comment on what evaluative criteria or methods we should use to assign risk weights to direct loans to System associations. How should the criteria be used to adjust the risk weight as the quality of the direct loan changes over time?*

#### *D. Small Agricultural and Rural Business Loans*

Our existing risk-based capital rules assign small agricultural and rural business loans to the 100-percent risk-weight category unless the credit risk is mitigated by an acceptable guarantee or acceptable collateral. The standardized approach of Basel II applies a 75-percent risk weight to certain retail claims<sup>39</sup> provided: (1) The exposure is to an individual person or persons or to a small business, (2) the exposure is in the form of a revolving credit, line of credit, personal term loan or lease, or small business facility or commitment, (3) the regulatory supervisor is satisfied that the retail portfolio is sufficiently diversified to warrant such a risk weight, and (4) the total credit exposure to the borrower does not exceed approximately \$1.4 million.<sup>40</sup>

*Question 6: We seek comment on what approaches we should use to improve the risk sensitivity of our risk-based capital rules for small agricultural and rural business loans. More specifically, what criteria should we use to classify an agricultural or rural business as a small business? What criteria should we use to assign risk-weights of less than 100 percent to these types of loans?*

#### *E. Loans Secured by Liens on Real Estate*

The FCA is considering ways to use loan-to-value ratios (LTV) and other criteria to determine the risk-based capital charges for farm real estate and qualified residential loans. Our existing capital rules assign farm real estate loans to the 100-percent risk-weight category and qualified residential loans<sup>41</sup> to the 50-percent risk-weight

category. The standardized approach of Basel II assigns a 35-percent risk weight to all prudently underwritten residential mortgages. Basel IA had proposed to risk-weight loans secured by first and second liens on residential real estate based on LTV. We continue to believe that LTV is a viable option for determining appropriate risk-weights for farm real estate and qualified residential loans. We are also considering approaches that would combine borrower creditworthiness and other loan characteristics in conjunction with LTV.

*Question 7: We seek comment on all aspects of using LTV to determine the appropriate risk-weight for farm real estate, qualified residential loans, or any other asset class. We also welcome comments on other methods that could be used to improve the risk sensitivity of our risk-based capital rules for these types of loans.*

#### *F. Loans 90 Days or More Past Due or in Nonaccrual*<sup>42</sup>

Our existing risk-based capital rules assign most loans to the 100-percent risk-weight category unless the credit risk is mitigated by an acceptable guarantee or collateral. When exposures reach 90 days or more past due or are in nonaccrual status, there is a higher probability that the financial institution might incur a loss. The standardized approach of Basel II addresses this potentially higher risk of loss by assigning the unsecured portion of a loan that is 90 days or more past due (net of specific provisions) as follows:

- 150-percent risk weight when specific provisions are less than 20 percent of the outstanding amount of the loan;
- 100-percent risk weight when specific provisions are 20 percent or more of the outstanding amount of the loan;
- When specific provisions are 50 percent or more of the outstanding amount of the loan, the supervisor has the discretion to reduce the risk weight to 50 percent.

*Question 8: We seek comment on all aspects related to risk-weighting exposures that reach 90 days or more past due or are in nonaccrual status.*

#### *G. Short- and Long-Term Commitments*

Under § 615.5212, off-balance sheet commitments are generally risk-weighted in two steps: (1) The off-balance sheet commitment is multiplied

by a credit conversion factor (CCF)<sup>43</sup> to determine its on-balance sheet credit equivalent; and (2) the on-balance sheet credit equivalent is assigned to the appropriate risk-weight category in § 615.5211 according to the obligor, after considering any applicable collateral and guarantees.<sup>44</sup> The standardized approach of Basel II assigns a 0-percent CCF to unconditionally cancelable commitments,<sup>45</sup> a 20-percent CCF to short-term commitments, and a 50-percent CCF to long-term commitments.<sup>46</sup>

*Question 9: We seek comment on what approaches we should use to risk weight short- and long-term commitments that are not unconditionally cancelable.*

#### *H. Adjusting Risk Weights on Exposures Over Time*

The FCA welcomes comment on additional approaches or criteria that might be used to adjust the risk weight of exposures throughout the life of the asset. Our existing risk-based capital rules assign a static risk weight to assets within a given asset class without providing for risk-weight adjustments as asset quality improves or deteriorates. For example, most loans to System borrowers are risk-weighted at 100 percent throughout the life of the loan without making risk-weight adjustments based on credit classifications or other credit performance factors.

*Question 10: We seek comment on what methods we should use to adjust the risk weight of credit exposures as the asset quality or default probability changes over time.*

#### *I. Capital Charge for Operational Risk*

The FCA welcomes comments on possible approaches for determining a capital charge for operational risk. The broad risk-weighting categories under our existing capital rules are primarily

<sup>43</sup> A CCF is a number by which an off-balance sheet item is multiplied to obtain a credit equivalent before placing the item in a risk-weight category.

<sup>44</sup> Our existing regulations assign a 0-percent CCF to unused commitments with an original maturity of 14 months or less. Unused commitments with an original maturity of greater than 14 months can also receive a 0-percent CCF provided the commitment is unconditionally cancelable and the System institution has the contractual right to make a separate credit decision before each drawing under the lending arrangement. All other unused commitments with an original maturity of greater than 14 months are assigned a 50-percent CCF.

<sup>45</sup> An unconditionally cancelable commitment is one that can be canceled for any reason at any time without prior notice.

<sup>46</sup> Basel IA proposed to retain the 0-percent CCF for all unconditionally cancelable commitments, apply a 10-percent CCF to all other short-term commitments, and retain the 50-percent CCF for all long-term commitments.

<sup>39</sup> The other Federal financial regulatory agencies stated in Basel IA that they were exploring options to permit certain small business loans to qualify for a 75-percent risk weight.

<sup>40</sup> We present a comparable threshold in terms of U.S. dollars. The standardized approach of Basel II has a threshold of €1 million.

<sup>41</sup> Qualified residential loans are rural home loans (as defined by 12 CFR 613.3030) and single-family residential loans to bona fide farmers, ranchers, or

producers or harvesters of aquatic products that meet the requirements listed in 12 CFR 615.5201.

<sup>42</sup> This section was not in the previous ANPRM.

designed to protect against credit or counterparty risk. As we move toward a more risk-sensitive capital framework, it may be appropriate to apply an explicit capital charge for operational risk, especially to cover risks associated with off-balance sheet activity.

Basel II defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people, systems, or from external events. This definition includes legal risk but excludes strategic and reputational risk. As previously mentioned, Basel II has three methods for applying a capital charge for operational risk. Under the basic indicator approach, the operational capital charge is equal to 15 percent of the 3-year average of positive annual gross income. Under the standardized approach, the operational capital charge is equal to the sum of a fixed percentage of the 3-year average of the gross income of eight business lines.<sup>47</sup> Under the AMA, the operational capital charge is derived from a bank's internal operational risk management systems and processes.

*Question 11: We seek comment on what approach we should consider, if any, in determining a risk-based capital charge for operational risk.*

#### J. Disclosure<sup>48</sup>

The FCA recognizes that market discipline contributes to a safe and sound banking environment and enhances risk management practices. Pillar III of Basel II is designed to complement the minimum capital requirements and supervisory review process by encouraging market discipline through meaningful public disclosure. The disclosure requirements are intended to allow market participants to assess key information about an institution's risk profile and associated level of capital to better evaluate risk management performance, earnings potential and financial strength.

Pillar III of Basel II presents the following general disclosure requirements: (1) Banks should have a formal disclosure policy approved by the board of directors that addresses the institution's approach for determining

the disclosures it should make;<sup>49</sup> (2) banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency of them; (3) banks should decide which disclosures are relevant based on the materiality concept;<sup>50</sup> and (4) the disclosures should be made on a semi-annual basis, subject to certain exceptions.<sup>51</sup>

The other Federal financial regulatory agencies have proposed the following additional requirements in the advanced capital framework: (1) The disclosures would follow U.S. generally accepted accounting principles, SEC mandates, and existing regulatory reporting requirements; (2) the banks would be required to disclose quantitative information on a quarterly basis following SEC deadlines; (3) the disclosures would be made publicly available (for example, on a Web site) for each of the last 3 years (that is, 12 quarters);<sup>52</sup> (4) disclosure of key financial ratios must be provided in the footnotes to the year-end audited financial statements;<sup>53</sup> (5) the chief financial officer must certify that the disclosures are appropriate; and (6) the board of directors and senior management are responsible for establishing the internal control structure over financial reporting.

*Question 12: We seek comment on all aspects of the Basel II public disclosure requirements. Specifically, how would the System apply the public disclosure requirements of Pillar III given its unique cooperative structure?*

#### K. Capital Leverage Ratio

We are considering whether we should supplement our existing risk-based capital rules with a minimum capital leverage ratio requirement for all FCS institutions to further promote the safety and soundness of the System. Our existing capital regulations require System banks to maintain a minimum

net collateral ratio (NCR)<sup>54</sup> of 103 percent<sup>55</sup> but do not impose a capital leverage ratio on System associations. The NCR provides a level of protection for operating and other forms of risk at System banks, but it does not differentiate higher quality from lower quality capital. The other Federal financial regulatory agencies currently supplement their risk-based capital rules with a leverage ratio of Tier 1 capital to total assets (Tier 1 leverage ratio).<sup>56</sup> The Tier 1 leverage ratio consists of only the most reliable and permanent forms of capital such as common stock, non-cumulative perpetual preferred stock, and retained earnings.

*Question 13: We seek comment on whether our capital rules should include a minimum capital leverage ratio requirement for all System institutions. We also seek comment on changes, if any, that should be made to the existing regulatory minimum NCR requirement applicable to System banks that would make it more comparable to the Tier 1 ratio used by the other Federal financial regulatory agencies.*

#### L. Regulatory Capital Directives<sup>57</sup>

We are considering whether we should modify our capital rules to specify potential early intervention criteria for the issuance of capital directives. Currently, FCA has the discretion to issue a capital directive<sup>58</sup> when an institution's capital is insufficient. The FCA, however, has not defined capital or other financial early intervention thresholds to require an institution to take corrective action as described in § 615.5355. Early intervention approaches have been used in other contexts, including the System's Market Access Agreement and the statutory requirements applicable to other regulated financial institutions.<sup>59</sup> An early intervention capital directive framework could provide a clearer

<sup>54</sup> The net collateral ratio is a bank's net collateral as defined in 12 CFR 615.5301(c) divided by the bank's adjusted total liabilities.

<sup>55</sup> See 12 CFR 615.5335(a).

<sup>56</sup> See 12 CFR 3.6(b) and (c); 12 CFR part 208, appendix B and 12 CFR part 225, appendix D; 12 CFR 325.3; and 12 CFR 567.8.

<sup>57</sup> 12 CFR part 615, subpart M.

<sup>58</sup> A capital directive is defined in § 615.5355(a) as an order issued to an institution that does not have or maintain capital at or greater than the minimum ratios set forth in 12 CFR 615.5205, 615.5330, and 615.5335, or established under subpart L of part 615, or by a written agreement under an enforcement or supervisory action, or as a condition of approval of an application. The FCA's authority is set forth in sections 4.3(b)(2) and 4.3A(e) of the Farm Credit Act (12 U.S.C. 2154(b)(2) and 2154a(e)).

<sup>59</sup> See 12 U.S.C. 1831o for the prompt corrective action provisions that apply to commercial banks and savings associations.

<sup>47</sup> Each business line is multiplied by a fixed percentage and then summed together to determine the annual gross income. The eight lines of business are corporate finance (18 percent), trading and sales (18 percent), retail banking (12 percent), commercial banking (15 percent), payment and settlement (18 percent), agency services (15 percent), asset management (12 percent), and retail brokerage (12 percent).

<sup>48</sup> This section was not in the previous ANPRM.

<sup>49</sup> Disclosure is a qualifying criterion under Pillar I to obtain lower risk weightings and/or to apply specific methodologies.

<sup>50</sup> Pillar III of Basel II provides minimum disclosure requirements on capital structure and adequacy, and risk exposure and assessment on credit risk, market risk, operational risk, equities, and interest rate risk in the banking book.

<sup>51</sup> Disclosure of key capital ratios should be made on a quarterly basis. Qualitative disclosures providing a general summary of a bank's risk management objective and policies, reporting system and definitions may be published on an annual basis.

<sup>52</sup> U.S. Basel II banks are encouraged to provide this information in one place on the entity's public Web site.

<sup>53</sup> These disclosures would be tested by external auditors as part of the financial statement audit.

indication of when we would impose additional and increasing supervisory oversight on an institution to address continuing deterioration in its financial condition and capital position from credit, interest rate, or other financial risks.

*Question 14: We seek comment on revising our current capital directive regulations to include an early intervention framework. We also seek comment on potential financial thresholds, such as capital ratios or risk measures, that would trigger an FCA capital directive action.*

#### **M. Multi-Dimensional Regulatory Structure**

As stated above, one of FCA's objectives is to implement a revised capital framework that improves the risk sensitivity of our capital rules while avoiding undue regulatory burden. There are currently five banks and 95 associations in the System with varying degrees of asset size, complexity of operations, and sophistication in their risk management practices. Some System institutions have the risk management capabilities to apply more complex, risk-sensitive regulatory capital requirements than other System institutions. It may be appropriate for the FCA to adopt more than one set of capital rules to account for these differences. However, this approach could result in different capital requirements for the same type of transaction and increase examination and oversight costs.

As described above, the other Federal financial regulatory agencies are in the process of proposing two sets of capital rules for the financial institutions they regulate. The implementation of the advanced capital framework would be limited, for the most part, to the largest, internationally active banks that meet certain infrastructure requirements. Other banks would implement a simpler capital framework patterned after the standardized approach of Basel II.

While our expectation is to implement a revised capital framework similar to the standardized approach of Basel II, we also recognize that some aspects of the advanced approaches may be appropriate for the larger, more complex System institutions. However, we are still reviewing the advanced approaches of Basel II and its potential application to the System. Therefore, we are not seeking comments on specific aspects of the advanced approaches at this time. Rather, we are considering the overall regulatory capital framework for the System in light of the changes occurring in the financial services

industry and recent best practices for economic capital modeling.

*Question 15: We seek comment on the most appropriate risk-based capital framework for the System and the reasons we should implement one framework over another. Should we consider creating a uniform regulatory capital structure for the System or a multi-dimensional regulatory structure and allow each System institution the option of choosing which capital framework it will apply? How might this new risk-based capital framework increase the costs or regulatory burden to the System? Would the increased costs be justified by improved risk sensitivity, risk management, and more efficient capital allocation?*

#### **N. Reporting Requirements and Transition Period<sup>60</sup>**

The other Federal financial regulatory agencies have announced that they will be replacing Basel IA with a proposed rule that would provide all non-core banks the option of adopting the standardized approach under Basel II. Their stated intent is to finalize a standardized approach for non-core banks before the core banks begin their first transition period year under the advanced capital framework. Our objective is to minimize, to the extent possible, the time interval between the issuance of their final rule and ours. We also need a transition period to make appropriate modifications to the Call Reporting System to track the new risk-based capital requirements.

*Question 16: We seek comment on an appropriate timetable for implementing our new risk-based capital rules. Specifically, what is an appropriate time interval between the issuance of the other Federal financial regulatory agencies' final rule on the standardized approach of Basel II and ours? How long should the transition period be to allow System institutions to adjust to the new risk-based capital rules?*

*Question 17: Additionally, we seek comment on any other methods that may be used to increase the risk sensitivity of our risk-based capital rules.*

Dated: October 25, 2007.

**Roland E. Smith,**

Secretary, Farm Credit Administration Board.  
[FR Doc. E7-21422 Filed 10-30-07; 8:45 am]

**BILLING CODE 6705-01-P**

## **SMALL BUSINESS ADMINISTRATION**

### **13 CFR Part 121**

**RIN 3245-AF67**

#### **Small Business Size Standards; Fuel Oil Dealers Industries**

**AGENCY:** U.S. Small Business Administration.

**ACTION:** Proposed rule.

**SUMMARY:** The U.S. Small Business Administration (SBA) proposes to change the small business size standard for the Heating Oil Dealers industry (North American Industry Classification System (NAICS) code 454311) from \$11.5 million in average annual receipts to 50 employees, and the size standard for the Liquefied Petroleum Gas (Bottled Gas) Dealers industry (NAICS code 454312) from \$6.5 million in average annual receipts to 50 employees. Large and fluctuating increases in the prices of heating oil and propane over the past several years indicate that a more stable measure of firm size based on number of employees rather than receipts is needed for these two industries.

**DATES:** SBA must receive comments to this proposed rule on or before November 30, 2007.

**ADDRESSES:** You may submit comments, identified by RIN 3245-AF67, by one of the following methods: (1) Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments; or (2) Mail/Hand Delivery/Courier: Gary M. Jackson, Assistant Director for Size Standards, 409 Third Street, SW., Mail Code 6530, Washington, DC 20416.

SBA will post all comments on [www.Regulations.gov](http://www.Regulations.gov). If you wish to submit confidential business information (CBI) as defined in the User Notice at [www.Regulations.gov](http://www.Regulations.gov), please submit the information to Diane Heal, Office of Size Standards, 409 Third Street, SW., Mail Code 6530, Washington, DC 20416, or send an e-mail to [sizestandards@sba.gov](mailto:sizestandards@sba.gov). Highlight the information that you consider to be CBI and explain why you believe SBA should hold this information as confidential. SBA will review the information and make the final determination of whether it will publish the information or not.

**FOR FURTHER INFORMATION CONTACT:** Diane Heal, Office of Size Standards, (202) 205-6618 or [sizestandards@sba.gov](mailto:sizestandards@sba.gov).

**SUPPLEMENTARY INFORMATION:** Several small businesses, trade associations, and Members of Congress have requested that SBA review the \$11.5 million size

<sup>60</sup> This section was not in the previous ANPRM.