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–AB76

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

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA), by the FCA Board (Board), proposes to amend the investment regulations to provide Farm Credit System (Farm Credit, FCS, or System) banks with a broader array of eligible investments. Under the proposed regulations, Farm Credit banks are expected to hold only high-quality and liquid investments to maintain a liquidity reserve, invest surplus funds, and manage interest rate risk. The proposal provides System banks with guidance on sound practices for managing risks associated with investment activities and grants System banks greater flexibility to manage risk on an institutional, portfolio, or individual instrument level. These amendments are also designed to better enable FCS banks to adjust to the rapid and continual changes in the financial markets.

DATES: Written comments should be received on or before August 17, 1998.

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

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

I. Background

Petitions by System banks, various developments and innovations in the securities markets, and improvements in risk management technologies have all led the FCA to reexamine its investment management regulations in subpart E of part 615. The FCA aims to develop a regulatory framework that establishes certain fundamental practices each Farm Credit bank should follow to fully understand and effectively manage the risks inherent in its investment portfolio. Although non-agricultural investments are a relatively small percentage of the assets of Farm Credit banks, proper investment management enables System banks to control risks stemming from their operations as monoline providers of agricultural credit. The FCA's proposal is specifically designed to enhance investment management practices at Farm Credit banks, and many aspects of this proposal are consistent with the policies that the Federal Financial Institutions Examination Council (FFIEC) recently adopted in a document entitled ''Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities.'' [1]

The proposed amendments enable FCA to relax or repeal many of the detailed criteria that the existing regulations prescribe for specific types of investments. As a result, § 615.5140 will provide broader parameters for various classes of investments while retaining essential safety and soundness controls, such as credit ratings and diversification standards.

II. Investment Portfolio Management

Board and senior management should develop and implement comprehensive risk management processes to effectively identify, measure, monitor, and control risks associated with investment activities. Although risk management programs will differ among System banks, certain elements are fundamental to all sound risk management programs. Safe and sound banking practices require System banks to have programs to manage the market, credit, liquidity, operational, legal, and other risks associated with investment activities. Effective risk management also addresses risks in individual instruments, the investment portfolio, and the entire institution.

Proposed § 615.5133 sets forth the fundamental criteria for developing sound investment management practices at Farm Credit banks. Senior management, under the oversight of the board of directors, should adhere to investment practices that are appropriate for the bank's individual circumstances and consistent with these regulations. The failure to understand and manage the risks associated with investment activities will generally be considered an unsafe and unsound banking practice.

A. Investment Policy Requirements

Many aspects of the current investment management regulations are retained in this proposal. However, the complexity of many financial products, both on- and off-balance sheet, compels the FCA and other Federal financial institution regulators to advocate a more comprehensive and institution-wide approach to risk management. Thus, the FCA is proposing to strengthen, redesign, and reorganize this section.

1. Board and Senior Management Oversight

The introductory paragraph to proposed § 615.5133 outlines the basic responsibilities of the board of directors regarding the investment activities of its bank. The proposed rule requires the board to adopt written policies that specifically identify the purposes and objectives, risk parameters, delegations of authority, and reporting requirements for managing the bank's investment portfolio. The investment policy should also address how investment activities affect the institution's capital and earnings. For this reason, a Farm Credit bank board may include its investment policy in a broader asset-liability management (ALM) or risk management policy.

Oversight by both the board of directors and senior management of each Farm Credit bank is an integral

[1] *See* 63 FR 20191 (April 23, 1998).

part of an effective risk management program. The board of directors is responsible for ensuring that management and operational personnel have the requisite skills and resources to manage the risks associated with investment activities in accordance with the board's policies. Annually, the board of directors of each Farm Credit bank must review its investment policies to determine whether objectives and risk exposure limits continue to be appropriate for the bank. Senior management discharges its responsibility by adhering to the board's policies, providing advice to the board, and safely and soundly conducting investment activities on both a strategic and operational basis.

2. Risk Limits

Proposed § 615.5133(a) requires the board's policies to define the risk parameters for the bank's investment activities. Foremost, risk parameters are to be based on the strength of each Farm Credit bank's capital position and its ability to measure and manage risk. The risk parameters should be consistent with the bank's broader business strategies and institutional objectives. The bank's investment policies should identify the risk characteristics of permissible investments and establish risk limits and diversification requirements for the various classes of eligible investments and the investment portfolio. The policies of each Farm Credit bank should control credit, market, liquidity, and operational risks associated with investment activities.

B. Credit Risk

A System bank should not acquire investments without assessing the creditworthiness of issuers, obligors, or other counterparties. Credit risk generally refers to the risk that an issuer, obligor, or other counterparty will default on its obligation to pay the investor under the terms of the security or instrument.

Proposed § 615.5133(a)(1) requires each System bank to establish comprehensive policies to control credit risk in its investment portfolio. Each Farm Credit institution must maintain a well-diversified investment portfolio. As a result, every Farm Credit bank should limit concentrations relating to single or related counterparties, geographical areas, industries, or obligations with similar characteristics.

The FCA proposes to delete current § 615.5133(i) relating to specific credit risk controls on investments in collateralized mortgage obligations (CMOs), real estate investment conduits (REMICs), and asset-backed securities (ABS), in favor of the broader language proposed in § 615.5133(a)(1)(i). Nevertheless, the FCA continues to expect banks to address concentration risks associated with CMOs, REMICs, mortgage-backed securities (MBS), and ABS by establishing appropriate portfolio limits on each of these investments. More specifically, the policy of each Farm Credit bank should address minimum pool size, the minimum number of loans in a pool, geographic diversification of a pool, and maximum allowable premiums.

As part of its efforts to control credit risks, Farm Credit banks should consider the ability of counterparties to honor their obligations and commitments. The selection of dealers, brokers, and investment bankers (collectively, securities firms) is an important aspect of effective management of counterparty credit risk. Proposed § 615.5133(a)(1)(ii) requires bank boards of directors to identify the criteria for selecting securities firms. A satisfactory approval process includes a review of each firm's financial statements and an evaluation of its ability to honor its commitments, including an inquiry into the general reputation of the securities firm. In some situations, it is also prudent for System banks to review information from Federal or State securities regulators and industry self-regulatory organizations such as the National Association of Securities Dealers concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel. Proposed § 615.5133(a)(1)(ii) also requires the board of directors to set limits on the amounts and types of transactions that the bank can execute with authorized securities firms. The board of directors must annually review management's selection of securities firms and limitations on transactions with such firms.

Proposed § 615.5133(a)(1)(ii) responds to requests by System banks for modifications in the FCA's policy concerning the board's role in selecting securities firms, financial institutions, and other counterparties. The proposed rule would no longer require the board of directors to approve specific depository institutions where the bank holds certificates of deposits and Federal funds. The FCA originally imposed this requirement on System banks at a time when small, isolated, and financially weak commercial banks were offering brokered deposits with high rates of return.[2] Reforms in the commercial banking industry and a widespread awareness of the risks inherent in such instruments have lessened FCA's regulatory concern. Furthermore, proposed § 615.5140(a)(4)(i) sets minimum credit and maturity limits for investments in certificates of deposits, Federal funds, and bankers acceptances.

Proposed § 615.5133(a)(1)(iii) requires Farm Credit banks to establish appropriate collateral margin requirements for repurchase agreements.[3] The FCA is proposing this amendment, in part, because proposed § 615.5140(a)(4)(iv) would expand the types of securities that Farm Credit banks may accept as collateral in repurchase transactions. As a means of managing potential counterparty credit risk, it is prudent for System banks to establish appropriate collateral margin requirements based on the quality of the collateral and the terms of the agreement. Farm Credit banks should also manage their exposure to loss on repurchase agreements by regularly marking the collateral to market and maintaining control of the collateral.[4]

C. Market Risk

From a safety and soundness perspective, it is crucial for the management of a Farm Credit bank to fully understand the market risks associated with investment securities prior to acquisition and on an ongoing basis. Market risk is the risk to a bank's financial condition resulting from adverse changes in value of its holdings arising from movements in interest rates or prices. The most significant market risk of investment activities is interest rate risk. Proposed § 615.5133(a)(2) would require bank boards to establish limits on market risk exposure at the institutional, portfolio, or individual instrument level. This change corresponds with pending changes in other parts of the FCA regulations that address interest rate risk management.[5]

To manage market risk exposure, System banks should evaluate how

[2] *See* 58 FR 63034, 63040 (November 30, 1993).

[3] In general, whether a given agreement is termed a ''repurchase agreement'' or a ''reverse repurchase agreement'' depends largely on which party initiated the transaction. Market participants typically view the transaction from the dealer's perspective. In this preamble and the proposed regulation, the FCA uses the term ''repurchase agreement'' regardless of the perspective from which the transaction is viewed.

[4] For a more detailed discussion on managing risks associated with repurchase agreements, Farm Credit banks should review the FFIEC's modified policy statement on repurchase agreements with securities dealers and others. *See* 63 FR 6935 (February, 11, 1998).

[5] The FCA's proposed capital regulations provide more detailed discussions of FCS institution responsibilities as they relate to interest rate risk management. *See* 62 FR 49623 (September, 23, 1997).

individual instruments and the investment portfolio as a whole affect the bank's overall interest rate risk profile. Bank's should monitor the price sensitivity of its investment portfolio and specify institution-wide interest rate risk limits. In addition, banks may find it useful to establish interest rate risk limits on the investment portfolio or on certain types of securities. Risk parameters should be commensurate with the bank's ability to measure, manage, and absorb risk. Boards should consider the bank's level of capital and earnings and its tolerance for market risk exposure when setting risk parameters. Market risk limits should be established in a manner that is consistent with all relevant regulations, policies, and guidance issued by the FCA.

D. Liquidity Risk

The FCA expects Farm Credit banks to manage liquidity risk at both the investment and the institutional levels. System banks may encounter liquidity risk stemming from market conditions surrounding individual investment activities. In this context, liquidity risk is the risk that a bank would not be able to easily sell or liquidate an investment quickly at a fair price. This inability may be due to inadequate market depth or market disruption. At the institutional level, liquidity risk is the risk that System banks could encounter a liquidity crisis if they are unable to fund operations at reasonable rates because access to the capital markets is impeded. This impediment may result from a market disruption or real or perceived credit problems.

The FCA proposes to repeal a provision in existing § 615.5134(b) which requires System banks to segregate investments held in the liquidity reserve from investments that are maintained for the other purposes permitted by existing § 615.5132. As a result of this amendment, System banks will have greater flexibility to decide how best to use their investments to manage exposure to risk.[6] Since the liquidity characteristics of an investment influence whether it is suitable for meeting particular institutional objectives, the FCA also proposes a conforming change to § 615.5133(a)(3). Pursuant to this amendment, the bank's policies must specify the desired liquidity characteristics of investments that it will use for maintaining a liquidity reserve and accomplishing other institutional objectives.

The bank's investment policies must also require the bank to maintain sufficient quantities of liquid investments to comply with the liquidity reserve requirements of § 615.5134. Pursuant to § 615.5132, each Farm Credit bank's total investments, including its liquidity reserve, cannot exceed 30 percent of its total outstanding loans. The FCA expects the policies of each Farm Credit bank to strike an appropriate balance between the need for a liquidity reserve, the management of interest rate risk, and the investment of surplus funds as it strives to accomplish its institutional objectives.

E. Operational Risk

Operational risk occurs when deficiencies in internal controls or information systems result in unexpected loss to a financial institution. Operational risk may arise from inadequate procedures, human error, information system failure, or fraud. Internal controls that effectively detect and prevent operating risks are an integral part of prudent investment management. The ability of management to accurately assess and control operating risks is often one of the greatest challenges that financial institutions face from investment activities. Therefore, proposed § 615.5133(a)(4) would require the board of directors of each Farm Credit bank to address operating risks by establishing policies that foster effective internal controls.

Organizational structure and reporting lines should clearly delineate responsibility and accountability for all investment management functions, including risk measurement, risk management, and oversight. Organizational structure should periodically be reviewed to reveal conflicts of interest or inadequate checks and balances. Proposed § 615.5133(b) specifically requires System banks to identify who has delegated authority to conduct investment transactions and the extent of that authority. In addition, the proposed rule requires a separation of duties and supervision between personnel executing investment transactions and those responsible for approving, revaluating, and overseeing the bank's investments. Separation of duties promotes integrity, accuracy, and reasonable business practices that reduce the risk of loss. Senior management must ensure that bank investment practices and risk exposure are regularly reviewed and evaluated by personnel who are independent from those responsible for executing investment transactions.

Existing § 615.5133(h), which the FCA proposes to modify and redesignate as § 615.5133(c), requires Farm Credit banks to establish appropriate internal controls to monitor their investment activities and prevent loss, fraud, embezzlement, conflicts of interest, and unauthorized investment practices. Redesignated § 615.5133(c)(1) adds conflicts of interest as an issue that every System bank must specifically address in its investment policies. The policies of each Farm Credit bank should provide guidelines to prevent or resolve conflicts of interest that may arise from employees who are directly involved in purchasing and selling securities. Furthermore, the bank's policies should ensure that all directors, officers, and employees act in the best interest of the institution.

Due to the increasingly complex nature of investment instruments, Farm Credit banks must maintain information systems that are capable of monitoring, measuring, and evaluating the risks inherent in their investment activities. Proposed § 615.5133(c)(3) would require banks to maintain management information systems that are commensurate with the nature, scope, and complexity of the bank's investment activities. Internal quantitative models and management expertise must be adequate to analyze individual investment instruments, the investment portfolio, and the effect investments have on the bank's cashflows, earnings, and capital.

Farm Credit banks may also be exposed to other sources of operating risks, such as legal risk that may result from contracts that are not legally enforceable. The FCA expects each bank to adequately assess and control other operational risks relating to investment activities. Accordingly, Farm Credit banks should clearly define documentation requirements for securities transactions, retention and safekeeping of documents, as well as possession and control of purchased instruments.

F. Securities Valuation

Accurate and frequent securities valuation is essential to measuring risk and monitoring compliance with the bank's objectives and risk parameters. Proposed § 615.5133(d) establishes the basic requirements for securities valuations by Farm Credit banks.[7]

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[6] The minimum liquidity reserve that System banks maintain under § 615.5134 must be sufficient to fund their operations for approximately 15 days in the event that System access to the capital markets becomes impeded.

[7] Two provisions of this regulation, § 615.5133(d)(1) and (d)(2) are new, while existing

Continued

System banks must understand the value and price sensitivity of their investments prior to purchase and on an ongoing basis. System banks should rely on valuation methodologies that take into account all the risk elements in a security to determine its price. Appropriate securities valuation practices enable managers to fully understand the risks and cashflow characteristics of the investments.

A critical step in sound investment management is the independent verification of securities prices. Accordingly, proposed § 615.5133(d)(1) requires each Farm Credit bank, at the time of purchase or sale, to verify the value of the security (except new issues) with a source that is independent of the broker, dealer, counterparty, or other intermediary in the specific transaction. Under the proposed rule, independent verification of price can be as simple as obtaining a price from an industry-recognized information provider. Although price quotes from information providers are not actual market prices, they confirm whether the broker's price is reasonable. In the event that a bank is unable to obtain a second price quote on a particular security, a price quote may be obtained on a security with substantially similar characteristics.

Proposed § 615.5133(d)(2) requires Farm Credit banks to determine, at least monthly, the fair value of each security in their portfolio and the fair value of the investment portfolio as a whole. This provision is added to the regulations to ensure that management has the necessary information to assess the performance of the bank's investment portfolio. Additionally, this requirement enables management to provide accurate and timely reports to the board of directors in accordance with proposed § 615.5133(e).

Existing § 615.5140(c) has been modified and redesignated as proposed § 615.5133(d)(3). Currently, § 615.5140(c) requires each Farm Credit bank to perform ongoing evaluations of all eligible investments in its portfolio and to support its evaluation with the most recent credit rating by at least one nationally recognized statistical rating organization (NRSRO). As amended, proposed § 615.5133(d)(3) specifically requires Farm Credit banks to perform evaluations of the credit quality and price sensitivity to changes in market interest rates of all investments held in its portfolio prior to purchase and on an ongoing basis. This change emphasizes that effective credit and interest rate risk management is vital to successful FCS bank operations.

The substance and form of the evaluations are likely to vary depending on the type of instrument. Relatively simple or standardized instruments with readily identifiable risks require significantly less analysis than more volatile or complex instruments. Proposed § 615.5141 contains specific stress testing guidance for evaluating the price sensitivity of mortgage securities. Other eligible investments that have uncertain cashflows as a result of embedded options (such as call options, caps or floors) may require similar analytical techniques to appropriately evaluate the instruments. For example, prior to investing in ABS, the FCA expects a bank to conduct or obtain an evaluation of the collateral (including type, aging of the assets, and the credit quality of the underlying loans) and an analysis of the securities' structure and cashflows.

System banks must continue to support their credit evaluations by the most recent credit rating with a NRSRO. However, Farm Credit banks should not rely exclusively on NRSRO ratings prior to purchasing investments because there may be a lag before an adverse event is reflected in the credit rating.

G. Reports to the Bank's Board

Adequate reporting enables bank boards to properly discharge their fiduciary responsibilities. The investment policy should define routine reporting requirements and the means for reporting exceptions to policy. Management reports need to communicate effectively to the board of directors the nature of the risks inherent in the bank's investment activities. Reporting should occur frequently so that the board has timely, accurate, and sufficient information to understand how changes in the investment portfolio affect the balance sheet and the bank's risk profile. The FCA proposes to modify the second sentence of existing § 615.5133(h) to emphasize these points and to redesignate it as § 615.5133(e).

Proposed § 615.5133(e) requires quarterly reports on the performance (i.e., gains or losses) and risk of individual investments and the investment portfolio. Key risks should be specifically identified and discussed in the report. More specifically, reports should relate potential risk exposure to changes in market interest rates and any other factors (such as credit deterioration) that may affect the value of the bank's investment holdings. In addition, proposed § 615.5133(e) requires management reports to discuss how investments affect the bank's overall financial condition and to evaluate whether the performance of the investment portfolio effectively achieves the objectives established by the board of directors. Reports should specifically identify any deviations from the board's policies.

III. Eligible Investments

A. Overview

Section 615.5140 lists the eligible investments that System banks may purchase and hold to maintain a liquidity reserve, manage interest rate risk, and invest surplus short-term funds. Associations are also authorized to hold eligible investments listed in § 615.5140 to invest surplus funds and reduce interest rate risk pursuant to existing § 615.5141 (redesignated as § 615.5142). 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 both existing and proposed § 615.5140 generally have short maturities and maintain a high investment grade credit rating by an NRSRO. Furthermore, all eligible investments are either traded in active secondary markets or are valuable as collateral.

The proposed rule provides System institutions with a broad array of high-quality and liquid investments. The FCA proposes to expand the list of eligible investments and to relax or repeal certain restrictions in existing § 615.5140. These revisions reflect changes in the financial markets as well as the FCA's desire to develop a regulatory framework that can more readily accommodate innovations in financial products and analytical tools.

The FCA Board proposes to restructure the format of § 615.5140 to accommodate eligible investments that are newly authorized by the FCA and to provide an organizational structure that is easy to understand. Similar classes of investments, such as full faith and credit obligations of Federal and State governments and short-term money market instruments are now grouped together in proposed § 615.5140(a). The FCA proposes to reduce the number of portfolio caps and repeal existing regulatory restrictions on the amount that each FCS institution can invest in negotiable certificates of deposit, Federal funds, bankers acceptances, and prime commercial paper.

Requirements that apply to several categories of eligible investments have been relocated to § 615.5140(b). For example, the requirement that an investment must be marketable will now be covered by a single provision in

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§ 615.5140(d) has been modified and redesignated as proposed § 615.5133(d)(3).

proposed § 615.5140(b)(1). Additionally, the sovereign rating for political and economic stability of foreign countries, which is currently repeated several times in the existing regulation, is relocated to proposed § 615.5140(b)(2).

The FCA is proposing to revise its regulatory terminology for credit ratings. References to the credit ratings of specific NRSROs are omitted from the proposed rule so it more accurately encompasses the broad universe of market ratings. Instead, the proposed regulation requires each eligible investment listed in § 615.5140(a) to maintain a specified long-term or short-term credit rating by an NRSRO that is recognized by the Securities and Exchange Commission (SEC). Whereas the existing regulation refers, for example, to a Standards and Poor's (S&P) Corporation rating of ''AA'' or its equivalent, the proposed regulation refers to ''the highest two credit ratings by an NRSRO.'' The following table provides a comparative illustration of S&P's investment grades for both long-term and short-term issue credit ratings.

Investment grade	S&P ratings	
	Long-term	Short-term
First	AAA	A–1
Second	AA	A–2
Third	A	A–3
Fourth	BBB	

The ratings in the table are often modified by either plus or minus signs to show relative standing within a major rating category. Specific investment credit ratings in the proposed rule refer to the generic rating categories, not modifiers within the generic group. Thus, for example, a long-term rating of ''AA−'' by S&P would be, for the purposes of FCA's regulations, within the ''two highest credit ratings by an NRSRO.''

The following section provides a category-by-category discussion of the FCA's proposed regulatory framework for eligible investments.

B. U.S. Treasury and Agency Securities

The FCA retains § 615.5140(a)(1) without revision. This provision authorizes each FCS institution to invest in obligations that are backed by the full faith and credit of the United States, its agencies, instrumentalities, and corporations. In response to frequent questions about the scope of this provision, the FCA confirms that § 615.5140(a)(1) permits the purchase of debt obligations of other Government-sponsored enterprises (GSEs). Private obligations that are fully insured or guaranteed as to both principal and interest by the United States, its agencies, instrumentalities, or corporations are also covered by this regulation. Thus, for example, a System institution may hold federally insured deposits, loans that are guaranteed by either the Export-Import Bank of the United States or the Overseas Private Investment Corporation, and certain obligations of the Small Business Administration.

C. Municipal Securities

The FCA proposes to redesignate § 615.5140(a)(10), which authorizes the investment in the general obligations of State and municipal governments, as § 615.5140(a)(2), without significant change. The FCA proposes to add a definition of ''general obligation of a State or political subdivision'' to § 615.5131 to codify its recent guidance on which bonds are deemed to be backed by the full faith and credit of a State or local government.[8] Under this definition, general obligation bonds are those that are: (1) Full faith and credit obligations of a State or local government that possesses powers of general taxation; or (2) obligations of a governmental unit that lacks powers of general taxation if an obligor possessing general powers of taxation unconditionally guarantees to make all payments on these obligations.

System banks have requested authority to invest in municipal revenue bonds. These bonds are not supported by the taxation powers of the obligor and are repayable from fee income and other sources of revenue. Although many municipal revenue bonds are highly rated by NRSROs and are actively traded in secondary markets, others are not. The universe of municipal revenue bonds is also diverse, and effective regulation of System investment in these securities could be difficult. For these reasons, the FCA requests comments on how it could permit these investments while limiting risks to System institutions. Specifically, the FCA solicits comments on how the regulation could establish: (1) Criteria for determining which revenue bonds are suitable for meeting the investment purposes in § 615.5132; and (2) an appropriate limit on the amount of these investments.

D. International and Multilateral Development Banks

Obligations of the International Bank for Reconstruction and Development (World Bank) are eligible investments under existing § 615.5140(a)(3). The FCA's proposal expands the scope of this provision to include the obligations of other international and multilateral development banks (such as the Inter-American Development Bank and the North American Development Bank) in which the United States is a voting shareholder. This amendment recognizes other highly rated banks that work in concert with the World Bank to promote development in various countries.

E. Money Market Instruments

Several provisions of existing § 615.5140(a) authorize investments in negotiable certificates of deposit, Federal funds, bankers acceptances, prime commercial paper, and repurchase agreements. These money market instruments have high credit quality and short maturities. Additionally, they can be sold on active secondary markets prior to maturity. These qualities make them highly liquid and valuable as collateral. Accordingly, the FCA proposes to group all money market instruments together into a single regulatory provision, § 615.5140(a)(4). Since these money market instruments pose limited risks to investors, the FCA believes that this regulation should no longer impose specific limitations on the amounts of negotiable certificates of deposit, Federal funds, bankers acceptances, and prime commercial paper that each FCS institution could hold in its investment portfolio. However, § 615.5140(b)(3) continues to restrict the amount that an FCS institution could invest with a single obligor or institution to 20 percent of its total capital. The FCA is also proposing to omit the definitions of negotiable certificates of deposit, Federal funds, and Term Federal funds from existing § 615.5131 because the meanings of these instruments are commonly understood by participants in the money markets. Additionally, the FCA has relocated the definitions of prime commercial paper and repurchase agreements from existing § 615.5131 to proposed § 615.5140(a)(4) so these regulations are easier to read.

The FCA proposes to omit specific references to Eurodollar and Yankee certificates of deposits from § 615.5131 and § 615.5140 because proposed § 615.5140 (a)(4)(i) is sufficiently broad to permit investment in both of these instruments. The provision in existing § 615.5140(a)(5) regarding deposit insurance for domestic and Yankee certificates of deposit became redundant in 1996 when the FCA amended § 615.5140(a)(1) to specifically cover Federal insurance of private debt

[8] *See* FCA BL–038, ''Guidance Relating to Investment Activities,'' (November 26, 1997).

obligations.[9] Deposit insurance usually is not a consideration when an FCS institution purchases negotiable Eurodollar certificates of deposit because only a small portion of its investment is typically insured.

System banks requested authority to invest in Eurodollar time deposits. A Eurodollar time deposit is a non-negotiable deposit denominated in United States dollars that is issued by an overseas branch of a United States bank or by a foreign bank outside the United States. The riskiness of Eurodollar time deposits depends on both the creditworthiness of the issuing bank and the foreign country where the deposit is located. Financial institutions generally use Eurodollar time deposits as an alternative to Federal funds. Most Eurodollar time deposits mature within 180 days.

The FCA agrees that Eurodollar time deposits are suitable for investing short-term surplus funds and interest rate risk management. However, the FCA proposes several safety and soundness constraints for Eurodollar time deposits because these instruments are not negotiable and they are held at depository institutions outside of the United States. Specifically, proposed § 615.5140(a)(4)(ii) allows each FCS institution to invest in Eurodollar time deposits that mature within 90 days and that are issued by depository institutions that maintain the highest short-term issuer credit rating by an NRSRO. In addition, proposed § 615.5140(b)(2) further requires Eurodollar time deposits to be held at depository institutions located in foreign countries that maintain the highest sovereign rating for political and economic stability. The FCA also proposes to limit investments in Eurodollar time deposits to 20 percent of an FCS institution's total investment portfolio to control concentration risk in these non-negotiable instruments.

System banks also requested authority to invest in certificates of deposits that mature within 3 years but contain a put option that enables the investor to require the depository institution to repurchase the instrument. The FCA's research reveals that the market for certificates of deposits with embedded put options is almost nonexistent, and no commercial banks have issued these instruments in several years. These instruments are neither liquid nor traded in active secondary markets. Commercial banks have engineered the few existing certificates of deposits with put options for specific customers. Therefore, the FCA has not added these instruments to the list of eligible investments in the proposed rule.

Prime commercial paper remains an eligible investment under the proposed regulations. The FCA has redesignated § 615.5140(a)(7) as § 615.5140(a)(4)(iii).

The FCA proposes to expand the types of collateral that support eligible repurchase agreements. System banks have asserted that the FCA's investment eligibility criteria limit their ability to participate in the repurchase agreement market because market participants are often unwilling to post collateral that specifically complies with the investment criteria in existing § 615.5140. The FCA acknowledges that repurchase transactions can be a valuable tool for investing short-term surplus funds, and they are relatively safe due to short maturities, high quality of collateral, and collateral margin requirements. For this reason, the FCA proposes to amend this regulation. The proposed regulatory approach will allow more latitude to participate in this market, while maintaining essential safety and soundness controls.

Redesignated § 615.5140(a)(4)(iv) permits each FCS institution to invest in repurchase agreements where the FCS institution agrees to purchase marketable securities subject to a legal agreement that requires the counterparty to repurchase the same or identical securities at a specific price within 100 days or less. Any securities held as collateral in connection with repurchase agreements must be either eligible investments authorized by this section or other marketable securities that are rated in the highest credit rating category by an NRSRO. In the event that the counterparty defaults on the agreement and the FCS institution takes possession of the collateral, the divestiture requirements in existing § 615.5142 (redesignated as proposed § 615.5143) apply to any collateral that fails to qualify as an eligible investment under § 615.5140(a).

In 1995, the FCA approved a System request to invest in Master Notes pursuant to existing § 615.5140(a)(11), which permits the FCA to authorize additional investments on a case-by-case basis. As requested, the FCA proposes § 615.5140(a)(4)(v) to codify System institutions' authority to invest in Master Notes.[10] The proposed regulation authorizes investments in Master Notes that: (1) Are executed with a domestic counterparty that maintains the highest issuer short-term credit rating by an NRSRO; and (2) mature overnight or within 270 days under a callable contract. The FCA also proposes to increase the portfolio limit on Master Notes from 15 to 20 percent of the FCS institution's investment portfolio.

F. Mortgage Securities

1. Overview

Currently, § 615.5140(a)(2) authorizes investment in mortgage securities that are issued or guaranteed by the Government National Mortgage Association (Ginnie Mae or GNMA), the Federal National Mortgage Association (Fannie Mae or FNMA), and the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC). CMOs that are collateralized by mortgage securities of GNMA, FNMA and FHLMC are also expressly authorized under the current regulations, even though they are packaged, issued, and sold under a private label.[11] Under the existing regulation, eligible mortgage securities must either reprice within 1 year or comply with the stress tests specified in § 615.5140(a)(2)(iii).[12] System banks may hold mortgage securities that are issued or fully guaranteed by Ginnie Mae without restriction as to amount. However, the existing regulation restricts mortgage securities that are issued or fully guaranteed by Fannie Mae and Freddie Mac to 50 percent of each bank's total investments.

System banks seek further opportunities to invest in the mortgage securities market because of the high credit quality and liquidity of these securities. In particular, Farm Credit banks have requested authority to invest in mortgage securities that are collateralized by loans that do not comply with the FNMA and FHLMC underwriting standards and certain stripped mortgage-backed securities (SMBS). Recently, System banks petitioned the FCA to repeal the portfolio limit on Fannie Mae and Freddie Mac mortgage securities. This request also suggested that the revised regulation authorize FCS institutions to invest in mortgage securities that are rated within the two highest investment credit grades by an NRSRO. The

[9] *See* 61 FR 67187 (December 20, 1996).

[10] Master Notes are interest-bearing unsecured promissory notes that are issued by institutions to investors under a master note agreement. The most common type of master note agreement is a variable-amount note which is a type of open-ended commercial paper that allows the investment and withdrawal of funds on a daily basis and pays a daily interest rate tied to the commercial paper rate.

[11] *See* 58 FR 63035, (November 30, 1993). Private label mortgage securities are issued by commercial banks, thrifts, and private conduits. Unlike agency securities, private label mortgage securities must be registered with the SEC.

[12] Section 615.5174 permits Farm Credit banks and associations to invest in mortgage-related securities that are guaranteed by the Federal Agricultural Mortgage Corporation (Farmer Mac).

proposed rule permits investment in a greater variety of mortgage securities, subject to essential safety and soundness constraints.

2. Limits on FNMA and FHLMC Mortgage Securities

As previously noted, System banks requested that the FCA repeal the 50-percent investment portfolio limit on mortgage securities that are issued or guaranteed as to principle and interest by FNMA and FHLMC. System banks commented that no other financial institution regulatory agency places restrictions on the credit exposure to GSEs and that exposure limits on these securities should be left to the discretion of each bank.

At this time, the FCA does not propose to repeal the existing portfolio limits for FNMA and FHLMC mortgage securities. As explained in greater detail below, the proposed regulation significantly expands the authority of System institutions to purchase and hold mortgage securities. The FCA's proposal will permit System institutions to invest, for the first time, in non-agency mortgage securities. Under certain circumstances, System banks would also be able to hold mortgage derivative products, such as SMBS, for interest rate risk management. Additionally, the new regulations will enable System institutions to rely on alternate stress tests for measuring the price sensitivity of mortgage securities.

The FCA agrees with System commenters that the board and management of each FCS institution should establish risk exposure limits for all mortgage securities. A regulatory portfolio limit on FNMA and FHLMC mortgage securities does not absolve an institution's board or management of its responsibility to establish risk parameters that are based on the institution's unique risk-bearing capacity. The FCA also expects each FCS institution to maintain a well-diversified investment portfolio, regardless of whether these regulations impose a portfolio cap on particular classes of investments.

Regulatory portfolio limits enhance safety and soundness by limiting credit exposure, promoting diversification of System investment portfolios, and curtailing investments in securities that may exhibit considerable interest rate or liquidity risks. The FCA invites further comment about this issue.

3. Non-agency Mortgage Securities

The size and liquidity of the non-agency mortgage securities market has increased markedly since the implementation of the current regulations in 1993. The largest sector of the non-agency market is comprised of securities that are collateralized by "jumbo" mortgages with principal amounts that exceed the maximum limits for FNMA and FHLMC programs.[13]

The credit quality and liquidity of any particular non-agency mortgage security are dependent upon a myriad of factors, including the type of collateral and the structure, term, and originator of the issue. Non-agency mortgage securities are not explicitly or implicitly guaranteed by the United States, so these instruments typically require credit enhancements to receive a high rating. Credit enhancement is usually provided by some combination of issuer or third-party guarantee, letter of credit, over-collateralization, pool insurance, or subordination. As a result of these credit enhancements, highly rated non-agency mortgage securities enjoy low default rates.

The FCA determines that non-agency mortgage securities that maintain the highest credit rating by an NRSRO have sufficient protections against default risk. Proposed § 615.5140(a)(5)(ii) permits each System institution to invest in mortgage securities that are offered by private sector entities. Under this proposal, privately issued mortgage securities are eligible investments for System institutions if they are rated in the highest rating category by an NRSRO and they are collateralized by qualifying residential mortgages, meeting the requirements of the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA).[14] Prior to investing in such securities, every System bank must subject each non-agency mortgage security to stress testing in accordance with § 615.5141. Non-agency mortgage securities cannot exceed 15 percent of each institution's total investments. Furthermore, mortgage securities that are issued by any party other than Ginnie Mae cannot exceed 50 percent of each institutions' total investments. This amendment balances the System's request for a broader selection of mortgage securities with appropriate safety and soundness restraints.

4. Fixed-rate Mortgage Pass-through Securities

Currently, fixed-rate mortgage securities are eligible investments for System institutions if they satisfy the three-pronged stress test in existing § 615.5140(a)(2)(ii).[15] This stress test provides a basic method for measuring the price sensitivity of a mortgage security to changes in interest rates.[16] System banks requested that the FCA repeal the requirement in existing § 615.5140(a)(2) that subjects mortgage pass-through securities to the stress test. The Farm Credit banks asserted that interest rate risk in mortgage pass-through securities is easier to model and analyze and other federally regulated financial institutions are not subject to similar requirements.

The FCA believes that stress testing of all mortgage securities is a necessary discipline that enables each System institution to better understand and manage the risks inherent in these instruments. Therefore, the FCA does not incorporate the System's suggestion in this proposal. However, as discussed below, the FCA proposes significant changes to the stress-testing requirements for mortgage securities.

5. Other Mortgage-derivative Products

The FCA also plans 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.[17] System banks claim that the explicit ban on SMBS is overly broad and, as a

[13] Several other asset classes in the non-agency MBS market exist, including: (1) Housing and Urban Development paper; (2) high loan-to-value loans; (3) Community Reinvestment Act loans; and (4) loans to borrowers with conforming loan balances with other features that prevent agency securitization, such as low documentation, self-employment, and unique property features.

[14] 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). SMMEA amended several statutes to encourage private sector investment in certain mortgage-related securities. *See* Pub. L. 98–440, 98 Stat. 1689, October 3, 1984.

[15] A recent FCA bookletter explains the authority of System banks to invest in fixed-rate mortgage securities that convert to adjustable rate securities. *See* BL–038, "Guidance Relating to Investment Activities," (November 26, 1997).

[16] Under existing § 615.5140(a)(2)(ii), each fixed-rate mortgage security must have a weighted average life (WAL) of 5 years or less, and changes in its WAL and price cannot exceed specified percentages, assuming parallel and sustained shift in interest rates of 300 basis points.

[17] Existing § 615.5131(r) defines SMBS as "securities created by segregating the cashflows from the underlying mortgages or mortgage securities to create two or more new securities, each with a specified percentage of the underlying security's principal payments, interest payments, or combination of the two." Furthermore, existing § 615.5140(a)(2)(v)(A) and 615.5174(c) specifically prohibit System banks from acquiring SMBS that are issued by GNMA, FNMA, FHLMC, and the Farmer Mac. When the existing regulations were adopted, the FCA reasoned that SMBS exhibit extreme price volatility to shifting interest rates, and therefore, these instruments were not suitable for maintaining a liquidity reserve or managing interest rate risk. *See* 56 FR 65091, 65096 (December 18, 1991); 58 FR 63034, 63046 (November 30, 1993).

result, it excludes securities with limited interest rate risk. The FCA concludes that the explicit regulatory ban on certain mortgage-derivative products is unnecessary because all mortgage securities are subject to stress-testing requirements under both the current and proposed rules. 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.

Repeal of these regulatory restrictions will afford each System institution greater latitude to manage interest rate risks in the investment portfolio and its balance sheet. Although certain mortgage derivative products are risky because their prices may be subject to substantial fluctuations, the FCA recognizes that they can also be useful tools for reducing interest rate risk. Successful risk management of these instruments requires a thorough understanding of the principles that govern the pricing of these instruments. In general, FCA would view it as an unsafe and unsound practice to hold SMBS and inverse floaters for any purpose other than to reduce specific interest rate risks. Management must document, prior to purchase and each quarter thereafter, that the mortgage derivative product is reducing the interest rate risk of a designated group of assets or liabilities and the interest rate risk of the institution. However, if such an instrument exhibits only minimal price sensitivity under the stress test in proposed § 615.5141, a System institution would be allowed to purchase and hold the instrument for other purposes permitted by existing § 615.5132.

6. Stress-testing Requirements

Although credit risk on highly rated mortgage securities is minimal, these 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. 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. Therefore, 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. For these reasons, the FCA continues to believe that appropriate stress testing of all mortgage securities is necessary to gain a full understanding of the risks inherent in the instruments.

Originally, FCS banks requested technical modifications to FCA's existing regulatory stress test. System banks subsequently requested that the FCA repeal the regulatory stress test after the FFIEC rescinded a policy statement that required depository institutions to stress test mortgage derivative products.[18] The System banks commented that the FCA should make its regulatory approach consistent with the FFIEC's new policy.

In response, the FCA proposes significant changes to existing requirements for evaluating the price sensitivity of mortgage securities and determining their suitability. The FCA's revised regulatory approach reflects improvements in prepayment models and methodologies for evaluating and measuring the price sensitivity of a security. Specifically, this proposal would enable each FCS institution to choose between two alternative approaches for measuring and evaluating the price sensitivity of mortgage securities to interest rate fluctuations.

Under the first option, an FCS institution may continue to use a modified version of the existing three-pronged stress test. The FCA proposes to modify the third prong of the stress test, which establishes a price sensitivity limit for mortgage securities. Under proposed § 615.5141(a)(3), the estimated change in the price of the security cannot exceed 13 percent due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points. This revision, which was originally requested by System banks, corrects an inconsistency in the test that may arise under certain interest rate scenarios. This change affords more latitude for investment in mortgage securities.

[18] *See* 63 FR 20191 (April 23, 1998).

Proposed § 615.5141(b) allows the use of alternative stress tests to evaluate the price sensitivity of investments in mortgage securities. The FCA is permitting alternative stress tests because new risk management technologies better enable investors to measure interest rate risks in complex mortgage securities. Alternative stress tests must be able to measure the price sensitivity of mortgage instruments over different interest rate/yield curve scenarios prior to purchase and each quarter thereafter. The methodology that an FCS institution uses to analyze mortgage securities must be commensurate with the complexity of the instrument's structure and cashflows. For example, a pre-purchase analysis may show the effect of an immediate and parallel shift in the yield curve of plus and minus 100, 200, and 300 basis points. Depending on the instrument's complexity, such analysis may 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, such as interest rate volatility and changes in credit spreads. The methodology used to evaluate an instrument's price sensitivity should enable management to determine that the particular mortgage security: (1) Is compatible with the objectives and risk limits in the institution's investment policies; and (2) does not expose capital and earnings to excessive risk.

An FCS institution employing internal models for valuation and risk measurement of mortgage securities should have adequate procedures to validate the models and periodically review all elements of the modeling process, including assumptions and risk measurement methodologies and techniques. Any FCS institution that relies on third parties for valuation and risk measurement must understand the assumptions and techniques used. All analysis must be available for review by the Office of Examination of the FCA.

7. Other Technical Changes

The FCA proposes to replace the definitions of ''CMOs,'' ''mortgage-backed securities,'' and ''REMICs'' in existing § 615.5131(e), (l), and (p) with a single definition of ''mortgage securities'' in proposed § 615.5131(i), which encompasses mortgage pass-through securities and all mortgage derivative products. Although proposed § 615.5131(i) continues to refer to CMOs and REMICS, the FCA has omitted specific regulatory definitions for these securities from the regulation because

their meanings are commonly understood in the financial markets.

The FCA proposes to relocate the applicable regulatory provision governing ARM securities from § 615.5140(a)(2)(ii) to § 615.5141 and to delete the definition of ''adjustable-rate mortgage'' in existing § 615.5131(b) because it is redundant.

G. Corporate Debt Obligations and ABS

Currently, corporate debt obligations and ABS are subject to a single regulatory provision, existing § 615.5140(a)(8). Under the existing regulation, corporate bonds and ABS, *combined*, cannot exceed 15 percent of the total investments of each FCS institution. Under this proposal, corporate bonds and ABS would be governed by separate regulatory provisions, and the portfolio cap for each category would be 20 percent of total outstanding investments. The FCA's proposal to expand the portfolio limits for these two investments provides every FCS institution with greater flexibility to invest in these securities within reasonable risk diversification parameters.

Existing § 615.5140(a)(8)(ii) authorizes each FCS institution to invest in ABS that mature in 5 years, are collateralized by loans on new automobiles (CARs) or credit card receivables (CARDs), and maintain the highest investment grade credit rating by an NRSRO. The FCA adopted § 615.5140(a)(8)(ii) in 1993 when CARs and CARDs comprised approximately 80 percent of the ABS market and other types of ABS were not actively traded in the secondary markets.[19]

The scope and depth of the ABS market has expanded rapidly since 1993. As a result, System banks have requested authority to invest in ABS that are collateralized by other types of assets. Originally, System banks petitioned the FCA for authority to purchase and hold ABS that are secured by home equity loans, manufactured housing loans, agricultural equipment loans, student loans, and wholesale dealer automobile loans. Subsequently, System banks requested that the FCA amend the regulation so it places no restrictions on the types of collateral that securitize ABS. System banks assert that a high credit rating is more indicative of an ABS's liquidity than its underlying collateral. Farm Credit banks also suggested that the FCA revise the maturity limits on ABS to permit fixed-rate ABS that have both a final maturity of 7 years or less and a WAL of 5 years or less, and floating-rate ABS that have both a final maturity of 10 years or less and a WAL of 7 years or less.

This proposal adopts a modified version of the System's original recommendation.[20] Proposed § 615.5140(a)(6) would authorize investment in ABS that are collateralized by CARs, CARDs, home equity loans, manufactured housing loans, equipment loans, student loans, and wholesale dealer automobile loans. The FCA emphasizes that securities collateralized by home equity loans are ABS, not mortgage securities, under this proposal. The FCA finds that the market for these types of ABS is sufficiently developed and that these securities are suitable for meeting the objectives of § 615.5132. This broad array of ABS should provide FCS institutions with an ample selection of highly rated, fixed-income investments that have relatively stable cashflows.

Under proposed § 615.5140(a)(6), FCA specifies that the WAL for all eligible ABS cannot exceed 5 years *and* the final maturity cannot exceed 7 years. The FCA proposes to extend the final maturity from 5 to 7 years in recognition that ABS with final maturities of 7 years typically have much shorter WALs. This approach has the added advantage of facilitating comparisons between amortizing ABS and other fixed-income securities. The FCA does not adopt the System's suggestion regarding the maturity of adjustable-rate ABS for two reasons. Most ABS have final maturities that are shorter than the timeframe recommended by Farm Credit banks. Other factors, such as the frequency of repricing, periodic and life-time interest rate caps and the index to which the instrument is tied are important determinants of how the instrument will perform. Therefore, the FCA requests comments on how the regulations could address maturity limits for adjustable ABS.

The FCA anticipates that there will be further growth in the ABS market and active secondary markets will ultimately develop for ABS that are backed by other types of collateral. Thus, the FCA also requests comments on how it could develop a more flexible final regulation that would enable the regulator to establish criteria for determining the suitability of new types of ABS that financial markets may create.

The FCA proposes no substantive changes to the regulatory provisions that govern investments in corporate debt obligations. Under this proposal, existing § 615.5140(a)(8)(i) will be redesignated as § 615.5140(a)(7).

H. Shares in Investment Companies

The FCA believes that investment companies provide System institutions with another convenient method to diversify and manage risks. Therefore, the FCA proposes to authorize investment in shares of any investment company that is registered under section 8 of the Investment Company Act of 1940, 15 U.S.C. 80a–8, as long as the investment company's portfolio consists exclusively of securities that are authorized by § 615.5140. Prior to investing in a particular investment company, an FCS institution would be required by proposed § 615.5140(a)(8) to evaluate the investment company's risk and return objectives. As part of this evaluation, the FCS institution should determine whether the investment company's use of financial derivatives is consistent with its investment policies. For instance, the FCA would generally view it an unsafe and unsound practice for an FCS institution to invest in an investment company that uses financial derivatives for speculative purposes rather than as a risk management tool. Every System institution should maintain appropriate documentation on each investment, including a prospectus and analysis, so its investment and selection process can be audited and examined.

Proposed § 615.5140(b)(5) addresses how the obligor and portfolio limitations in § 615.5140(b)(3) and (b)(4) apply to an FCS institution's interest in an investment company. Generally, proposed § 615.5140(b)(5)(i) requires combining the institution's direct holdings of an eligible investment with its pro rata interest in the same type of instrument in the portfolio of an investment company for the purpose of complying with § 615.5140(b)(3), (b)(4)(i), and (b)(4)(ii). The FCA notes that aggregation is required only if this regulation subjects a particular investment to an obligor or portfolio limit. For example, prime commercial paper is subject to an obligor limit, but not a portfolio limit. As a result, the regulation requires aggregation to ensure that no more than 20 percent of an FCS institution's total capital is invested in the prime commercial paper of any single obligor. However, no regulatory restriction applies to the amount of prime commercial paper that an FCS institution may hold in its investment portfolio, either directly or through an investment company.

Proposed § 615.5140(b)(5)(ii) carves out two exceptions to this aggregation rule. The first exception applies to the

[19] *See* 58 FR 63034, 63050 (November 30, 1993).

[20] Although the System's recommendation did not address the credit rating for ABS, the FCA proposes to retain the requirement in the existing regulation that all eligible ABS maintain the highest credit rating by an NRSRO.

obligor limit, while the second exemption covers portfolio restrictions. Under § 615.5140(b)(5)(ii)(A), an FCS institution may elect not to combine its pro rata interest in a particular security in an investment company with its direct holdings of securities that are issued by the same obligor if the investment company's holdings of the securities of any one issuer do not exceed 5 percent of its total portfolio. Pursuant to § 615.5140(b)(5)(ii)(B), an FCS institution may elect not to combine its pro rata interest in a type of security in an investment company with its direct holding of a class of securities that are subject to the portfolio limits if its shares in a particular investment company do not exceed 10 percent of its total investments.

I. Other Eligible Investments

The FCA proposes to redesignate existing § 615.5140(a)(11) as § 615.5140(a)(9). This proposal contains no substantive amendments to this provision, which allows the purchase of other short-term investments, as authorized by the FCA that are marketable and highly rated by an NRSRO. Whenever possible, the FCA seeks to repeal regulatory prior-approval requirements that are not mandated by the Act. The FCA requests comments on how the final regulation could permit FCS institutions, under certain circumstances, to invest in short-term, highly rated, marketable securities that are not expressly authorized by § 615.5140 without requiring Agency approval.

IV. Technical Amendments

The FCA proposes several conforming amendments to § 615.5174 relating to investments in securities issued by Farmer Mac. The terminology for mortgage securities has been revised so that it is consistent with proposed amendments to § 615.5131.

The FCA proposes to repeal the definitions of ''asset-liability management,'' ''Federal funds,'' ''interest rate risk,'' ''market value of equity,'' ''net interest income,'' ''total capital,'' and ''weighted average maturity'' in § 615.5131 because the meanings of these terms are commonly understood in financial markets. Separately, the FCA has redefined ''absolute final maturity'' in § 615.5131(a) as ''final maturity'' in proposed § 615.5131(c).

The FCA also proposes to repeal § 615.5142(a) and remove the designation from paragraph (b) because this provision is obsolete. Existing § 615.5142(a) pertains to the divestiture of investments that were rendered ineligible when the FCA originally adopted these regulations in 1993.

List of Subjects in 12 CFR Part 615

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

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

2. Subpart E is amended by revising the heading to read as follows:

Subpart E—Investment Portfolio Management

3. Section 615.5131 is revised to read as follows:

§ 615.5131 Definitions.

For purposes of this subpart, the following definitions shall 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) *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.

(c) *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 shall not mean the call date, the expected average life, the duration, or the weighted average maturity.

(d) *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 payable from a special fund or by an obligor not possessing general powers of taxation when an obligor possessing general powers of taxation, including property taxation, has unconditionally promised to make payments into the fund or otherwise provide funds to cover all required payments on the obligation.

(e) *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 bid and ask prices is narrow and a reasonable amount can be sold at those prices.

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

(g) *Market risk* means the risk to the bank's financial condition resulting from a decline in value of its holdings arising from changes in interest rates or market prices. A bank's exposure to market risk can be measured by assessing the effect of changing rates and prices on either earnings or economic value of an individual instrument, a portfolio, or the entire institution.

(h) *Marketable investment* means an asset that can be sold with reasonable promptness at a price that reasonably reflects its fair value in an active and universally recognized secondary market.

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

(1) Collateralized with residential mortgage loans (excluding home equity loans) that represent ownership of a fractional undivided interest in a specific pool of mortgages (commonly known as pass-through securities or participation certificates), or

(2) A multi-class, pay-through bond backed by a pool of residential mortgage pass-through securities or residential mortgage loans (including securities commonly known as collateralized mortgage obligations and real estate mortgage investment conduits).

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

(k) *Weighted average life (WAL)* means the average time to receipt of principal, weighted by the size of each principal payment. Weighted average

life for mortgage and asset-backed securities is calculated under specific prepayment assumptions.

4. Section 615.5133 is revised to read as follows:

§ 615.5133 Investment portfolio management.

The board of directors of each Farm Credit bank is responsible for adopting written policies for managing the bank's investment activities. The board of directors shall also ensure that the bank's investments are safely and soundly managed in accordance with the written policies and that appropriate internal controls are in place to preclude investment actions that undermine the solvency and liquidity of the bank. Written investment policies must address the purposes and objectives of investments, risk parameters, delegations of authority, and reporting requirements. Annually, the board of directors of each Farm Credit bank shall review its investment policies to determine whether objectives and risk exposure limits continue to be appropriate for the bank.

(a) *Risk parameters.* The investment policies shall establish risk limits and diversification requirements for the various classes of eligible investments and the entire investment portfolio. Risk parameters shall be based on the Farm Credit bank's institutional objectives, capital position, and its tolerance for risk. The policies must identify the types and quantity of investments that the bank will hold to achieve its objectives and control credit, market liquidity, and operational risks.

(1) *Credit risk.* The bank's investment policies shall establish:

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

(ii) Criteria for selecting brokers, dealers, and investment bankers (collectively, securities firms). The policy shall also set limits on the amounts and types of transactions that the bank shall execute with authorized securities firms. The board of directors shall annually review management's selection of securities firms and limitations on transactions with such securities firms.

(iii) Collateral margin requirements on repurchase agreements.

(2) *Market risk.* The bank's investment policies shall set market risk limits for the institution, the investment portfolio or specific types of investments pursuant to the regulations in this chapter and guidance by the Farm Credit Administration.

(3) *Liquidity risk.* The bank's policies shall describe the liquidity characteristics of investments used to accomplish institutional objectives and its liquidity needs sufficient to comply with the requirements of § 615.5134.

(4) *Operational risk.* The bank's policy shall address operational risks, including delegations of authority and internal controls in accordance with paragraphs (b) and (c) of this section.

(b) *Delegations of authorities.* All delegations of the management of the bank's investments to specific personnel or committees shall state the extent of management's authority and responsibilities.

(c) *Internal controls.* Each Farm Credit bank shall:

(1) Establish appropriate internal controls to detect and prevent loss, fraud, embezzlement, conflicts of interest, and unauthorized investments and ensure compliance with policies established by the board.

(2) Ensure that a separation of duties and supervision exists between personnel executing investment transactions and those responsible for approving, revaluating, and overseeing the bank's investments.

(3) Maintain management information systems that are commensurate with the level and complexity of the bank's investment activities.

(d) *Securities valuation.* Each Farm Credit bank shall:

(1) Verify the value of any security (except new issues) that it purchases or sells from a source that is independent of the broker, dealer, counterparty, or other intermediary in the specific transaction.

(2) Determine, at least monthly, the fair value of each security in its portfolio and the fair value of the portfolio as a whole.

(3) Perform evaluations of the credit quality and price sensitivity to changes in market interest rates of all investments held in its portfolio prior to purchase and on an ongoing basis.

(e) *Reports to the board.* Reports on the performance and risk of each investment and the investment portfolio shall be made to the board of directors or a committee thereof each quarter. Reports shall identify potential risk exposure to changes in market interest rates and other factors that may affect the value of the bank's investment holdings. Each report shall discuss how investments affect the bank's overall financial condition and evaluate whether the performance of the investment portfolio effectively achieves the objectives established by the board of directors. Any deviations from the board's policies shall be specifically identified in the report.

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

§ 615.5134 Liquidity reserve requirement.

* * * * *

(b) All investments held for the purpose of meeting the liquidity reserve requirement under this section shall be free of lien.

* * * * *

6. Section 615.5140 is revised to read as follows:

§ 615.5140 Eligible investments.

(a) Farm Credit banks are authorized to hold the following types of eligible investments, denominated in United States dollars, to comply with the requirements of §§ 615.5132, 615.5134, and 615.5135 of this subpart:

(1) *Treasury and agency securities.* Obligations of the United States; full-recourse obligations, other than mortgage securities, of agencies, instrumentalities or corporations of the United States, or debt obligations of other obligors that are fully insured or guaranteed as to both principal and interest by the United States, its agencies, instrumentalities, or corporations.

(2) *General obligations of a State or political subdivision* that mature within 10 years and are rated in one of the three highest credit rating categories by an NRSRO.

(3) *Obligations of international and multilateral development banks* in which the United States is a voting shareholder.

(4) *Money market instruments:* (i) Negotiable certificates of deposit that mature within 1 year or less, Federal funds, term Federal funds that have a callable contract with a term to maturity of 100 days or less, and bankers acceptances that are issued by depository institutions. All issuers of money market instruments listed in paragraph (a)(4)(i) of this section shall maintain a rating in one of the two highest short-term credit rating categories by an NRSRO.

(ii) Eurodollar time deposits that mature within 90 days and are held at depository institutions that maintain a rating in the highest short-term credit rating category by an NRSRO.

(iii) Prime commercial paper that has a maturity of 270 days or less and is rated in the highest short-term credit rating category by an NRSRO.

(iv) Repurchase agreements where a Farm Credit bank agrees to purchase marketable securities subject to an agreement that requires a counterparty

to repurchase the same or identical securities at a specific time within 100 days or less. The collateral for repurchase agreements shall be either eligible investments authorized by this section or other marketable securities that are rated in the highest credit rating category by an NRSRO.

(v) Master notes that mature overnight, or have a callable feature and mature within 270 days, and are executed with domestic counterparties that maintain a rating in the highest short-term credit rating category by an NRSRO.

(5) *Mortgage securities* that are rated in the highest credit rating category by an NRSRO and are either:

(i) Agency mortgage securities that are issued or guaranteed as to principal and interest by the Government National Mortgage Association, the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, or

(ii) Non-agency 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).

(iii) Mortgage securities shall not be consider eligible investments, unless they comply with the requirements of § 615.5141 of this subpart.

(6) *Asset-backed securities* that are collateralized by credit card receivables, automobile loans, home equity loans, manufactured housing loans, equipment loans, student loans, or wholesale dealer automobile loans that are rated in the highest credit rating category by an NRSRO. The expected WAL on eligible ABS shall not exceed 5 years and the final maturity shall not exceed 7 years.

(7) *Corporate debt securities* that are rated within the two highest credit rating categories by an NRSRO, mature within 5 years and are not convertible into equity securities.

(8) *Investment companies.* Shares of an investment company registered under section 8 of the Investment Company Act of 1940, 15 U.S.C. 80a–8 (including mutual funds, unit investment trusts, and collective investment funds maintained by a national bank under 12 CFR part 9), provided that the portfolio of the investment company consists exclusively of eligible investments that are authorized by this section or § 615.5174 of this part. In addition, Farm Credit banks must evaluate the investment company's risk and return objectives and use of derivatives to ensure that the investment company's objectives and strategies for achieving its objectives are consistent with the bank's investment policies and the requirements of this subpart.

(9) *Other investments,* as authorized by the Farm Credit Administration, that have a short maturity and are rated investment grade by an NRSRO. A Farm Credit bank seeking approval of an investment under this paragraph should provide the Farm Credit Administration with documentation that describes the risk characteristics of the investment and explains the bank's purpose and objectives for making the investment.

(b) The authority of Farm Credit banks to hold the investments listed in paragraph (a) of this section is subject to the following requirements:

(1) *Marketable securities.* Except for the money market instruments listed in paragraph (a)(4) of this section, all other eligible investments shall be marketable within the meaning of § 615.5131(h).

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

(3) *Obligor limits.* Except for eligible investments covered by paragraph (a)(1) of this section and mortgage securities that are issued by or guaranteed as to principal and interest by the Government National Mortgage Association, Federal National Mortgage Association, or the Federal Home Loan Mortgage Corporation under paragraph (a)(5)(i) of this section, each Farm Credit bank shall not invest more than twenty (20) percent of its total capital in eligible investments issued by any single institution, issuer, or obligor.

(4) *Portfolio limits.* Subject to § 615.5132, each Farm Credit System bank is authorized to hold eligible investments listed in paragraph (a) of this section without limitation as to amount except:

(i) Mortgage securities shall not exceed fifty (50) percent of the bank's total investments authorized under this section provided that mortgage securities that are issued under paragraph (a)(5)(ii) of this section shall not exceed fifteen (15) percent of the bank's total investments. Mortgage securities that are issued by the Government National Mortgage Association shall not be subject to any restriction on amount.

(ii) Each of the following types of investments shall not exceed twenty (20) percent of the bank's total investments authorized under this section:

(A) Eurodollar time deposits;

(B) Master notes;

(C) Asset-backed securities; and

(D) Corporate bonds.

(5) *Limit on investment company holdings.* (i) *General.* A Farm Credit bank shall combine its direct holdings of eligible investments with its pro rata interest in the same type of instrument or obligor in the portfolio of an investment company for the purpose of complying with the obligor and portfolio limitations of paragraphs (b)(3), (b)(4)(i), and (b)(4)(ii) of this section.

(ii) *Alternate diversification requirements for investment companies.* (A) *Exemption from the obligor limit.* A Farm Credit bank may elect not to combine its pro rata interest in a particular security in an investment company with the bank's direct holdings of securities that are subject to the obligor limit in paragraph (b)(3) of this section if the investment company's holdings of the securities of any one issuer do not exceed five (5) percent of its total portfolio.

(B) *Exemption from the portfolio limits.* A Farm Credit bank may elect not to combine its pro rata interest in a type of security in an investment company with the bank's direct holding of a class of securities that are subject to the portfolio limits in paragraphs (b)(4)(i) and (b)(4)(ii) of this section if the bank's shares in an investment company do not exceed ten (10) percent of its total investments.

§ 615.5141 through 615.5143 [Redesignated]

7. 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.

Each Farm Credit bank shall perform stress tests to determine how interest rate fluctuations will affect the cashflows and price of all mortgage securities that it purchases and holds under § 615.5140(a)(5), as well as their overall affect on the earnings and capital of the bank. Adjustable mortgage securities that have a repricing mechanism of 12 months or less and tied to an index are not subject to stress testing. Farm Credit banks may conduct the stress tests in accordance with either paragraph (a) or (b) of this section.

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

(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 shall not be subject to paragraphs (a)(1) and (2) of this section if at the time of purchase, and each subsequent quarter, it bears a rate of interest that is below the contractual cap on the instrument.

(b) A Farm Credit bank may use alternative stress tests to evaluate the price sensitivity of its investments in mortgage securities. Alternative stress tests must be able to measure the price sensitivity of mortgage instruments over different interest rate/yield curve scenarios prior to purchase and each quarter thereafter. The methodology used to analyze mortgage securities shall be commensurate with the complexity of the instrument's structure and cashflows. Prior to purchase and quarterly thereafter, the stress test should determine that the mortgage security's risk is compatible with the bank's investment policies and the investment does not expose the bank's capital and earnings to excessive risks.

(c) In applying the stress tests in either paragraphs (a) or (b) of this section, each Farm Credit bank shall rely on verifiable information to support all of its assumptions, including prepayment and interest-rate volatility assumptions. All assumptions that form the basis of the bank's evaluation of the security and its underlying collateral shall be available for review by the Office of Examination of the Farm Credit Administration. Subsequent changes in the bank's assumptions shall be documented. If at any time after purchase, a mortgage security no longer complies with requirements in this section, the bank shall divest the security in accordance with § 615.5143 of this part.

§ 615.5143 [Amended]

8. Newly designated § 615.5143 is amended by removing paragraph (a) and the paragraph designation from paragraph (b).

Subpart F—Property and Other Investments

§ 615.5174 [Amended]

9. Section 615.5174 is amended by removing the words ''mortgage-backed securities (MBSs), as defined by § 615.5131(l), collateralized mortgage obligations (CMOs), as defined by § 615.5131(e), and Real Estate Mortgage Investment Conduits (REMICs), as defined by § 615.5131(p)'' in paragraph (a), and adding in their place, the words ''mortgage securities as defined by § 615.5131(l);'' by removing the words, ''as defined by § 615.5131(b),'' from paragraph (b)(1); by removing paragraph (c); and redesignating paragraphs (d) and (e) as paragraphs (c) and (d), respectively.

Dated: June 15, 1998.

Floyd Fithian,

Secretary, Farm Credit Administration Board.

[FR Doc. 98–16208 Filed 6–17–98; 8:45 am]

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DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. 98–CE–51–AD]

RIN 2120–AA64

Airworthiness Directives; Schempp-Hirth K.G. Model Cirrus Sailplanes

AGENCY: Federal Aviation Administration, DOT.

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: This document proposes to adopt a new airworthiness directive (AD) that would apply to certain Schempp-Hirth K.G. (Schemmp-Hirth) Model Cirrus sailplanes. The proposed AD would require modifying or replacing the connecting rod between the airbrake bellcranks, and replacing the existing 6 millimeter (mm) bolt with an 8 mm bolt. The proposed AD is the result of mandatory continuing airworthiness information (MCAI) issued by the airworthiness authority for Germany. The actions specified by the proposed AD are intended to prevent the threaded bolt that is welded to the connecting rod between the airbrake bellcranks from breaking, which could result in loss of airbrake control with a possible reduction/loss of sailplane control.

DATES: Comments must be received on or before July 21, 1998.

ADDRESSES: Submit comments in triplicate to the Federal Aviation Administration (FAA), Central Region, Office of the Regional Counsel, Attention: Rules Docket No. 98–CE–51–AD, Room 1558, 601 E. 12th Street, Kansas City, Missouri 64106. Comments may be inspected at this location between 8 a.m. and 4 p.m., Monday through Friday, holidays excepted.

Service information that applies to the proposed AD may be obtained from Schempp-Hirth Flugzeugbau GmbH, Krebenstrasse 25, Postfach 1443, D–73230 Kircheim/Teck, Germany. This information also may be examined at the Rules Docket at the address above.

FOR FURTHER INFORMATION CONTACT: Mr. Mike Kiesov, Aerospace Engineer, FAA, Small Airplane Directorate, 1201 Walnut, suite 900, Kansas City, Missouri 64106; telephone: (816) 426–6934; facsimile: (816) 426–2169.

SUPPLEMENTARY INFORMATION:

Comments Invited

Interested persons are invited to participate in the making of the proposed rule by submitting such written data, views, or arguments as they may desire. Communications should identify the Rules Docket number and be submitted in triplicate to the address specified above. All communications received on or before the closing date for comments, specified above, will be considered before taking action on the proposed rule. The proposals contained in this notice may be changed in light of the comments received.

Comments are specifically invited on the overall regulatory, economic, environmental, and energy aspects of the proposed rule. All comments submitted will be available, both before and after the closing date for comments, in the Rules Docket for examination by interested persons. A report that summarizes each FAA-public contact concerned with the substance of this proposal will be filed in the Rules Docket.

Commenters wishing the FAA to acknowledge receipt of their comments submitted in response to this notice must submit a self-addressed, stamped postcard on which the following statement is made: ''Comments to Docket No. 98–CE–51–AD.'' The postcard will be date stamped and returned to the commenter.

Availability of NPRMs

Any person may obtain a copy of this NPRM by submitting a request to the FAA, Central Region, Office of the Regional Counsel, Attention: Rules Docket No. 98–CE–51–AD, Room 1558, 601 E. 12th Street, Kansas City, Missouri 64106.