

on behalf of Southern Milk Sales (SMS). The action is necessary to assure that producer milk which historically has been associated with the market will continue to be pooled under the order.

EFFECTIVE DATES: November 1, 1993, through May 31, 1995.

FOR FURTHER INFORMATION CONTACT: Nicholas Memoli, Marketing Specialist, USDA/AMS/Dairy Division, Order Formulation Branch, Room 2968, South Building, P.O. Box 96456, Washington, DC 20090-6456, (202) 690-1932.

SUPPLEMENTARY INFORMATION: Prior document in this proceeding:

Notice of Proposed Suspension: Issued October 15, 1993; published October 22, 1993 (58 FR 54530).

The Regulatory Flexibility Act (5 U.S.C. 601-612) requires the Agency to examine the impact of a proposed rule on small entities. Pursuant to 5 U.S.C. 605(b), the Administrator of the Agricultural Marketing Service has certified that this action will not have a significant economic impact on a substantial number of small entities. This action will lessen the regulatory impact of the order on certain milk handlers and will ensure that dairy farmers will continue to have their milk priced under the order with which they have historically been associated and thereby receive the benefits that accrue from such pricing.

The Department is issuing this rule in conformance with Executive Order 12866.

This final rule also has been reviewed under Executive Order 12778, Civil Justice Reform. This action is not intended to have a retroactive effect, and it will not preempt any state or local laws, regulations, or policies, unless they present an irreconcilable conflict with the rule.

The Agricultural Marketing Agreement Act provides that administrative proceedings must be exhausted before parties may file suit in court. Under section 608c(15)(A) of the Act, any handler subject to an order may file with the Secretary a petition stating that the order, any provisions of the order, or any obligation imposed in connection with the order is not in accordance with law and request a modification of an order or to be exempted from the order. A handler is afforded the opportunity for a hearing on the petition. After a hearing the Secretary would rule on the petition. The Act provides that the district court of the United States in any district in which the handler is an inhabitant, or has its principal place of business, has jurisdiction in equity to review the Secretary's ruling on the petition,

provided a bill in equity is filed not later than 20 days after the date of the entry of the ruling.

Notice of proposed rulemaking was published in the Federal Register on October 22, 1993 [58 FR 54530], concerning a proposed suspension of certain provisions of the order. Interested persons were afforded opportunity to file written data, views, and arguments thereon. One comment was submitted in support of the action.

After consideration of all relevant material, including the proposal in the notice, the comments received, and other available information, it is hereby found and determined that for the months of November 1993 through May 1995 the following provisions of the order do not tend to effectuate the declared policy of the Act:

In § 1096.7(d)(3), the words "until the third consecutive month in which a greater proportion of such route disposition is made in such other marketing area".

Statement of Consideration

This action will suspend for the months of November 1993 through May 1995 a part of the pool plant definition which requires that plants having greater route disposition in another marketing area for three consecutive months be considered as pool plants under the other order.

According to Mid-America, SMS historically has pooled milk on the Greater Louisiana marketing order through sales to Guth Dairy, a pool distributing plant located in Lake Charles, Louisiana. Mid-America stated that Guth Dairy recently was awarded school milk contracts in Houston, Texas, and that, as a result, a greater portion of the plant's packaged milk sales will be distributed in the Texas marketing order, causing the plant to switch regulation from Order 96 to the Texas marketing order.

Mid-America pointed out that for the twelve-month period ending August 1993 the Texas order blend price at Lake Charles averaged 63 cents per hundredweight less than the Greater Louisiana Federal order blend price at Lake Charles. The proponent stressed that producers supplying milk to Guth Dairy and pooled on the Greater Louisiana order could not continue to afford to supply milk to Guth Dairy if Guth Dairy became regulated under the Texas order. Likewise, Guth Dairy could not afford to pay 63 cents more to producers to compete with other handlers in the Greater Louisiana marketing area for a supply of milk.

In recent months, the disparity in blend prices has increased even more

than the 12-month average. In August and September 1993, for example, the blend price per hundredweight under the Greater Louisiana order was \$1.15 and \$1.00, respectively, higher than the Texas order's blend price at the Lake Charles, Louisiana, location. In view of the price disparity between the two orders, the fact that Guth Dairy is located within the Greater Louisiana marketing area, the historical association of the dairy farmers supplying this plant with Order 96, and the lack of any opposition to the proposal, it is appropriate to suspend the language that would cause the plant to shift to the Texas order.

It is hereby found and determined that thirty days' notice of the effective date hereof is impractical, unnecessary, and contrary to the public interest in that:

(a) The suspension is necessary to reflect current marketing conditions and to assure orderly marketing conditions in the marketing area;

(b) This suspension does not require of persons affected substantial or extensive preparation prior to the effective date; and

(c) Notice of proposed rulemaking was given interested parties, and they were afforded opportunity to file written data, views, or arguments concerning this suspension.

Therefore, good cause exists for making this order effective November 1, 1993.

List of Subjects in 7 CFR Part 1096

Milk marketing orders.

For the reasons set forth in the preamble, title 7 part 1096 is amended as follows:

PART 1096—MILK IN THE GREATER LOUISIANA MARKETING AREA

1. The authority citation for 7 CFR part 1096 continues to read as follows:

Authority: Secs. 1-19, 48 Stat. 31, as amended; 7 U.S.C. 601-674.

§ 1096.7 [Temporarily suspended in part]

2. In § 1096.7(d)(3), the words "until the third consecutive month in which a greater portion of such route disposition is made in such other marketing area" are suspended.

Dated: November 23, 1993.

Eugene Branstool,
Assistant Secretary, Marketing and Inspection Services.

[FR Doc. 93-29287 Filed 11-29-93; 8:45 am]
BILLING CODE 3410-02-P

Food Safety and Inspection Service**9 CFR Part 381**

[Docket No. 89-008F]

RIN 0583-AB09

Use of Tricalcium Phosphate in Mechanically Deboned Chicken

AGENCY: Food Safety and Inspection Service, USDA.

ACTION: Final rule.

SUMMARY: The Food Safety and Inspection Service (FSIS) is amending the poultry products inspection regulations to permit the use of tricalcium phosphate in mechanically deboned chicken, in accordance with current good manufacturing practices, during the dehydration process to preserve the color of such dehydrated products. The final rule will allow tricalcium phosphate at a level not to exceed 2 percent of the weight of the mechanically deboned chicken before dehydration. Use of tricalcium phosphate at such level will sequester the iron present in the blood of mechanically deboned chicken during the dehydration process, thus preventing discoloration (browning) of the product. The final rule regulation is in response to a petition submitted by Henningsen Foods, Inc.

EFFECTIVE DATE: December 30, 1993.

FOR FURTHER INFORMATION CONTACT: Charles Edwards, Director, Product Assessment Division, Regulatory Programs, Food Safety and Inspection Service, U.S. Department of Agriculture, Washington, DC 20250, (202) 254-2565.

SUPPLEMENTARY INFORMATION:**Executive Order 12291**

The Agency has determined that this final rule is not a major rule under Executive Order 12291. It will not result in an annual effect on the economy of \$100 million or more; a major increase in costs or prices for consumers, individual industries, Federal, State or local government agencies or geographic regions; or significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in export or domestic markets.

Executive Order 12778

This final rule has been reviewed pursuant to Executive Order 12778, Civil Justice Reform. This final rule concerns the use of substances in poultry products. States are precluded from imposing any marking, labeling,

packaging, or ingredient requirements on federally inspected poultry products that are in addition to, or different than, those imposed under the Poultry Products Inspection Act (PPIA) (21 U.S.C. 467e). States may, however, exercise concurrent jurisdiction over poultry products that are outside official establishments for the purpose of preventing the distribution of poultry products that are misbranded or adulterated under the PPIA, or, in the case of imported articles which are not at such an establishment, after their entry into the United States. States that conduct poultry inspection programs must impose requirements at least equal to those imposed on federally inspected products and establishments under the PPIA. These States may, however, impose stringent requirements on such State inspected products and establishments.

No retroactive effect is to be given to this final rule. There are no administrative procedures which must be exhausted prior to any judicial challenge to the provisions of this rule. Prior to any judicial challenge to the application of its provisions to an inspector's decision relating to any inspection, applicable administrative procedures set forth in 9 CFR 381.35 must be exhausted.

Effect on Small Entities

The Administrator, FSIS, has determined that this final rule will not have a significant economic impact on a substantial number of small entities. The final rule will permit the use of an additional substance at the manufacturer's option.

For purposes of determining the potential impact of this final rule on small entities, FSIS estimates that 10 percent of the approximate 505 manufacturers that produce mechanically deboned chicken are small entities (approximately 50). Manufacturers opting to use tricalcium phosphate in mechanically deboned chicken, as prescribed in this final rule, will be required to revise the ingredients statement on product labels to show the presence of such substance (9 CFR 381.118). This would entail approximately \$1,000 in labeling costs for each product. Provided all eligible small entities opt to use tricalcium phosphate in mechanically deboned chicken, small entities would incur an estimated \$50,000 overall as a result of this rulemaking.

The costs associated with new label applications are covered under existing approved paperwork burdens of FSIS's prior label approval system. Thus, this final rule does not impose new

paperwork requirements on the industry.

Background**Henningsen Foods Petition**

On March 4, 1988, FSIS received a petition from Henningsen Foods, Inc., Omaha, Nebraska, to amend the poultry products inspection regulations to allow the use of tricalcium phosphate in mechanically deboned chicken during dehydration to avoid discoloration of the dehydrated product. During the process of dehydrating mechanically deboned chicken, the product becomes dark brown, resulting in a dehydrated product that is aesthetically unacceptable to the petitioner's customers who purchase the product for use in further processed products such as gravies, sauces, and dehydrated soups.

The petitioner claimed that the addition of tricalcium phosphate to mechanically deboned chicken would sequester the iron present in the blood of the poultry product during dehydration and prevent discoloration of the mechanically deboned poultry product.

Supporting data submitted by the petitioner was based on a series of color tests of samples of dehydrated mechanically deboned chicken with variable amounts of tricalcium phosphate added before dehydration ranging from 0 to 3 percent of the weight of the mechanically deboned chicken. (A copy of the supporting data is available for review in the FSIS Hearing Clerk's Office.) The data showed that the color of the mechanically deboned chicken was fully preserved during dehydration with the addition of tricalcium phosphate at the 2 percent level.

Current Regulations

The Food and Drug Administration (FDA) lists tricalcium phosphate as generally recognized as safe (GRAS) in 21 CFR 182.1217 when used in accordance with current good manufacturing practices. The poultry products inspection regulations currently do not permit the use of tricalcium phosphate in any poultry product.

Proposed Rule

On August 25, 1992, FSIS published a proposed rule (57 FR 38450) to permit the use of tricalcium phosphate in mechanically deboned chicken during the dehydration process, in accordance with current good manufacturing practices, to preserve the color of such dehydrated products. FSIS proposed to

amend the table of approved substances in 9 CFR 381.147(f)(4) to allow the use of tricalcium phosphate to preserve the color of mechanically deboned chicken during dehydration by preventing the development of a brown color. Tricalcium phosphate would be permitted in such product at a level not to exceed 2 percent of the ingoing weight of the product, i.e., before dehydration.

Discussion of Comments

FSIS received two comments in response to the August 25, 1992 proposed rule. The comments were submitted by a food processor and a trade association. Both commenters fully supported the proposal and suggested that the Agency act expeditiously in promulgating the final rule.

On the basis of the record in this proceeding, the Administrator has determined that (1) the use of tricalcium phosphate in mechanically deboned chicken is in compliance with applicable FDA requirements, (2) its use is functional and suitable for the intended purpose, (3) the substance is used at the lowest level necessary to accomplish its intended technical effect, and (4) the use of this substance in mechanically deboned chicken at the stated level will not render the treated product adulterated, misbranded, or otherwise not in accordance with the requirements of the Poultry Products Inspection Act. Accordingly, FSIS is adopting the proposed rule as published.

List of Subjects in 9 CFR 381

Food additives, Food labeling, Poultry inspection.

Final Rule

For the reasons set forth in the preamble, FSIS is amending 9 CFR part 381 to read as follows:

PART 381—POULTRY PRODUCTS INSPECTION REGULATIONS

1. The authority citation for part 381 continues to read as follows:

Authority: 7 U.S.C. 450, 21 U.S.C. 451–470, 7 CFR 2.17, 2.55.

2. In the table in § 381.147(f)(4), the Class of substance "Miscellaneous" is amended by adding at the end thereof the following:

§ 381.147 Restriction on the use of substances in poultry products.

* * * * *

(f) * * *

(4) * * *

Class of substance	Substance	Purpose	Products	Amount
Miscellaneous * * *	Tricalcium phosphate	To preserve product color during dehydration process.	Mechanically deboned chicken to be dehydrated.	Not to exceed 2 percent of the weight of the mechanically deboned chicken prior to dehydration, in accordance with 21 CFR 182.1217.

* * * * *

Done at Washington, DC, on November 22, 1993.

Eugene Branstool,
Assistant Secretary, Marketing and Inspection Services.

[FR Doc. 93-29136 Filed 11-29-93; 8:45 am]

BILLING CODE 3410-DM-M

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AB25

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Management of Investments, Liquidity, Interest Rate Risk, and Eligible Investments

AGENCY: Farm Credit Administration.
ACTION: Final rule.

SUMMARY: The Farm Credit Administration (FCA), by the Farm Credit Administration Board (Board) adopts final regulations that amend the regulations which govern the investment activities of Farm Credit System (FCS, System, or Farm Credit) banks. The final regulations allow Farm Credit Banks (FCBs), banks for cooperatives (BCs), and agricultural

credit banks (ACBs) to hold specified eligible investments, in an amount not to exceed 30 percent of the total outstanding loans of such banks, for:

- (1) Maintaining a liquidity reserve;
- (2) Investing short-term surplus funds; and

- (3) Managing interest rate risk (IRR).

These regulations also establish a liquidity reserve requirement for all FCS banks. These regulations require FCBs, BCs, and ACBs to measure and manage IRR in their portfolios. The FCA has also strengthened existing requirements that necessitate the board of directors of each bank to adopt investment policies and procedures that ensure that the bank's investment activities are conducted in a safe and sound manner. These regulations expand the list of eligible investments so FCS banks will further diversify their investment portfolios, but the FCA has placed limits on the amount, maturity, and credit rating of eligible investments in order to ensure the safety and soundness of such investment portfolios. The FCA is also adopting regulations governing investments by System banks in mortgage-related securities that are fully guaranteed as to principal and interest by the Federal Agricultural Mortgage Corporation (Farmer Mac).

EFFECTIVE DATE: The regulation shall become effective upon the expiration of 30 days after publication in the Federal Register during which either or both Houses of Congress are in session. Notice of the effective date will be published in the Federal Register.

FOR FURTHER INFORMATION CONTACT: Michael J. LaVerghetta, Senior Financial Analyst, Technical and Operations Division, Office of Examination, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4231,

or
Richard A. Katz, Senior Attorney, Regulatory Operations Division, Office of General Counsel, Farm Credit Administration, McLean, VA 22102-5090, (703) 883-4020, TDD (703) 883-4444.

SUPPLEMENTARY INFORMATION:

I. General

On December 18, 1991, the FCA proposed amendments to its regulations governing the investment activities of System banks. See 56 FR 65691. Essentially, the FCA proposed regulations that would have restricted the amount that each FCB, BC, or ACB could invest in certain eligible investments to 20 percent of its total outstanding loans. Under the FCA's

proposal, these eligible investments could only be used to maintain a liquidity reserve, manage short-term surplus funds, and reduce IRR. The FCA also proposed, for the first time, regulations that established a liquidity reserve and authorized investments for reducing IRR at all System banks. The proposed regulations would have also strengthened existing regulatory requirements that require the board of directors of each System bank to adopt investment policies and procedures that conform with applicable law, and ensure that competent personnel conduct the bank's investment activities in a safe and sound manner. The FCA also proposed to expand the list of eligible investments that Farm Credit banks could use to achieve permissible investment objectives. Under the proposed regulations, eligible investments would be subject to percentage of asset limitations, as well as maturity and credit rating requirements. The FCA's proposal would have required System banks to divest all ineligible investments within 6 months after final regulations became effective unless the Director of the Office of Examination granted an extension.

Although the initial comment period expired on February 18, 1992, the FCA subsequently extended the comment period until May 1, 1992, in response to the economic growth initiative of the former President of the United States. See 57 FR 7276 (March 4, 1992). The President's initiative required all Federal agencies to review their regulations, pursuant to five enumerated criteria, in order to: (1) Identify those regulations that impede economic growth; and (2) accelerate action on those regulations that promote growth. In extending the comment period, the FCA also invited commenters to evaluate the impact of the proposed regulations on economic growth by applying the five criteria in the President's initiative.

The FCA received comments about the proposed regulations from the Farm Credit Council (FCC), six FCS banks, Farmer Mac, the American Bankers' Association (ABA) and an investment banking firm. Some commenters, on their own initiative, submitted additional letters or information to supplement their original responses. The FCA received a second letter from the FCC that specifically evaluated the impact of the proposed regulations on economic growth pursuant to the criteria set forth in the President's initiative.

The FCC and one FCB requested that the FCA repropose these regulations

instead of adopting final regulations. These commenters reasoned that they should have an additional opportunity to comment because: (1) The investment regulations have potentially far-reaching implications on the future management and direction of the FCS; and (2) some commenters seek substantial revisions to the FCA's proposal.

After carefully considering this request, the FCA declines to repropose these regulations. Two separate comment periods have afforded interested parties ample opportunity to communicate their views and recommendations about these regulations to the FCA. Indeed, some commenters have responded to the FCA's proposal more than once. As a result, the FCA is aware of both FCS and non-System concerns about these regulations. Accordingly, the FCA incorporated many of the commenters' substantive and technical recommendations into the final regulations, while other suggestions were rejected for the reasons set forth below. The final regulations that the FCA adopts today are the logical outgrowth of its original proposal. Differences between the proposed and final regulations are primarily attributed to comments received from interested parties.

Reproposed regulations are unlikely to provide the FCA with additional information or guidance that would be useful in crafting these final regulations. Reproposal, however, would substantially delay implementation of new investment regulations. In the interim, Farm Credit banks would continue to operate under existing regulations which all System commenters judged as obsolete.

II. Economic Impact

As noted earlier, the former President of the United States unveiled an initiative for economic growth on January 30, 1992.¹ This initiative established five criteria for determining if a regulation promoted or impeded economic growth. First, the expected benefits of the regulation to society should clearly outweigh its costs. Second, the regulation should be fashioned to maximize the net benefits to society. Third, the regulation should rely, to the maximum extent possible, on performance standards instead of prescriptive command-and-control requirements. Fourth, the regulation should, to the maximum extent

possible, rely on market mechanisms. Finally, the regulation should be expressed with clarity and certainty to guide regulated entities, and it should be designed to avoid needless litigation.

Only the FCC commented on the economic impact of the FCA's proposed investment regulations by applying the five criteria. Specifically, the FCC asserted that the fixed liquidity reserve requirement of proposed § 615.5134 failed to maximize net benefits to society under the second criterion. Because proposed § 615.5133 would require the board of directors to establish limits on the amount of investments that could be placed through individual obligors, the FCC characterized the rule as imposing command-and-control requirements, instead of relying on performance standards, as suggested in the third criterion. The FCC argued that the investment ceiling in proposed § 615.5132 and the high credit ratings and constraints on mortgage-backed securities (MBSs) in proposed § 615.5140 ignored market mechanisms, in violation of the fourth criterion of the economic growth package. Finally, the FCC claimed that proposed § 615.5133, which would require the board of directors to formulate investment management policies at their banks, was not expressed with clarity or certainty, as required by the fifth criterion of the initiative.

The FCA has carefully reviewed these comments. In response, the FCA notes that its authority to promulgate regulations that promote economic growth under the guidelines is constrained by the Act. In this context, the FCA interprets the Act as requiring the cooperatively owned FCS to channel most of its funds into agricultural loans. Similarly, the FCA is responsible for ensuring that the activities of System banks are compatible with their status as government-sponsored enterprises (GSEs). These restraints make it difficult for the FCA to fully apply the criteria concerning market mechanisms and performance standards to these regulations. Nevertheless, the final investment regulations that the FCA adopts today should promote economic growth by enhancing the liquidity and financial strength of the FCS so it remains a reliable source of credit for rural America.

III. Investment Purposes

A. The FCA's Proposal

The FCA proposed to revise and redesignate an existing regulation, § 615.5135, which authorized Farm Credit banks to hold investment

¹ Presidential Memorandum dated January 28, 1992, addressed to certain Department and Agency Heads. The subject of the memorandum was "Reducing the Burden of Government Regulation."

portfolios solely for the purposes of maintaining sufficient liquidity, investing short-term funds, and managing short-term debt. The existing regulation specifically prohibited System banks from maintaining "investment portfolios primarily as a means of generating additional income."

As proposed by the FCA, redesignated § 615.5132 would have limited the size of a bank's investment portfolio to 20 percent of its outstanding loans. Farm Credit banks would be allowed to hold these investments solely for the purposes of: (1) Complying with a new liquidity reserve requirement in proposed § 615.5134; (2) managing short-term cashflow needs; and (3) reducing interest rate risk pursuant to proposed § 615.5135.

The FCA reasoned that the 20-percent limit on investments would balance two competing objectives by providing management with greater flexibility to reduce IRR and maintain adequate liquidity, while simultaneously ensuring that Farm Credit banks operated in a manner that is consistent with their GSE status. From the FCA's perspective, a liquid pool of investments affords some protection to Farm Credit banks in the event of market disruptions. Furthermore, carefully planned investment strategies enable System banks to combat maturity mismatches and interest rate fluctuations that threaten their solvency. However, the FCA proposed restrictions on the size and uses of the investment portfolio so System banks could not use their GSE status to borrow funds from the capital markets during periods of favorable interest rate spreads for the purpose of accumulating large investment portfolios for arbitrage activities. Furthermore, the proposed regulations were designed to ensure that System banks maintain adequate levels of liquidity even during times when interest rate spreads have a negative impact on balance sheets.

B. The Comments

The FCA received comments about proposed § 615.5132 from the FCC, four FCBs, two BCs, ABA, and an investment banking firm. Two other FCBs endorsed the FCC's position without further comment. Except for ABA, all commenters opined that the proposal to limit the investment portfolio to 20 percent of gross loans was too restrictive. Several commenters asserted that the FCA's approach concerning investment purposes was inflexible.

The ABA generally supported proposed § 615.5132. Since this commenter complained that System banks rely on investments to generate

earnings rather than contain risks, it endorsed those provisions in proposed § 615.5132 that restricted investments to the following purposes: (1) Maintenance of a liquidity reserve; (2) IRR reduction; and (3) short-term surplus funds management. While the ABA did not specifically comment about the proposed 20-percent investment-to-loan ratio, it strongly supported the fixed 15-day liquidity reserve requirement.

The FCC claimed that it was unreasonable for the FCA to impose overall restrictions on the aggregate investment holdings of Farm Credit banks unless specific facts and circumstances demonstrated that the System engaged in unsafe and unsound investment practices. The commenter asserted that federally regulated financial institutions and other GSEs are not subject to similar restrictions. The FCC argued that any regulatory limitation on the size of System investment portfolios actually threatens safety and soundness by impeding the ability of the banks to: (1) Maintain adequate liquidity; (2) manage IRR; and (3) build capital.

As an alternative, the FCC suggested that the size of the investment portfolio be limited to 30 to 35 percent of total outstanding loans at each bank. According to the commenter, a 30 to 35-percent limit would enhance management's flexibility to safely and soundly manage the investment portfolio without unduly increasing the risks to the banks' liquidity or solvency.

The FCC also suggested that the FCA amend provisions in § 615.5132 concerning investment purposes by authorizing System banks to hold investments for the purpose of "managing," rather than "reducing" IRR. The FCC requested that the regulation explicitly state that the objectives of § 615.5132 are not violated when Farm Credit banks produce net interest income (NII) to build capital.

The FCC urged the FCA to modify its positions on how banks calculate and fund their liabilities for liquidity. Specifically, FCC requested that the FCA exclude Farm Credit investment bonds, and the Contractual Interbank Performance Agreement (CIPA) from the overall investment limit.

The Farm Credit Bank of Texas (Texas Bank) endorsed the FCC's position, but it also expressed independent opinions about proposed § 615.5132. The bank opined that the proposed regulation is arbitrary and unobjective. Although the Texas Bank stated that it could accept an investment cap of 30 to 35 percent, it viewed regulatory restrictions on the size of investment portfolios as an impediment to the maintenance of a

liquidity reserve. The commenter noted the direct relationship between liquidity and refunding risk exposure at System banks. As the refunding risk exposure changes, the bank needs to adjust its actual level of liquidity. In this context, the liquidity formula also correlates to the bank's IRR.

The Texas Bank also believes that the FCA should recognize that it is not inherently wrong for Farm Credit banks to produce NII and increase capital as a by-product of managing their investments. Since Farm Credit banks must increase capital, build an insurance fund, meet CIPA targets, and retire Farm Credit System Financial Assistance Corporation (FAC) debt, the commenter argues that the FCA should allow System banks to use all of their assets to maximize their profitability.

The Texas Bank urged the FCA to amend § 615.5132 so System banks could hold investments for the purpose of managing IRR, rather than reducing it. In the commenter's opinion, the effective management of IRR is a discipline. The Texas Bank noted that there could be sound reasons for a Farm Credit bank to increase its IRR tolerance in certain scenarios.

The Farm Credit Bank of Columbia (Columbia Bank) expressed strong opposition to proposed § 615.5132. Essentially, this commenter complains that the proposed regulation: (1) Invades the legitimate commercial prerogatives of the board and managers of each bank; (2) is premised on the FCA's misunderstanding of the role of liquidity in the safe and sound management of Farm Credit banks; (3) misperceives the appropriate uses of investments in managing the risks that System banks face in a competitive market environment; and (4) imposes an arbitrary percentage limit on the size of the banks' investment portfolios.

The FCA also received a joint comment letter from the Farm Credit Bank of Springfield and the Springfield Bank for Cooperatives (Springfield Banks). The Springfield Banks agreed with the System's position that a maximum limit on investments should not be imposed by regulation. But if a limit were required, this commenter indicated that the FCA should consider the composition of each bank's loan portfolio. The Springfield Banks acknowledged that they primarily originate variable rate loans that reprice within 1 year. As a result, these banks fund their operations with short-term liabilities. This approach requires the Springfield Banks to maintain a high level of liquidity. According to the comment letter, the investment portfolios of both Springfield Banks

already exceed the proposed 20-percent limit. In this context, proposed § 615.5132 would require the Springfield Banks to adopt a different funding strategy in order to operate safely and soundly. The commenter recommended that the FCA limit the size of the investment portfolio to: (1) Forty-five (45) percent of variable rate loans and fixed rate loans that reprice within 1 year; and (2) fifteen (15) percent of all fixed rate loans with a maturity that is greater than 1 year.

The National Bank for Cooperatives (CoBank) endorsed the FCC's position on § 615.5132. However, CoBank requested that the FCA exclude Farm Credit investment bonds from the investment cap. This commenter reasoned that Farm Credit investment bonds are merely "pass through" items, and are neutral as to their effect on liquidity.

The investment banking firm supported the proposed diversification requirements as a sound basis for managing liquidity and IRR. The commenter suggested that the FCA limit the size of the investment portfolio to 50 percent of outstanding loans and further suggested suspension of this 50-percent limit if: (1) Interest rates fluctuate by more than 200 basis points during the prior 12 months; or (2) if borrowing capacity is restricted and the cost of System funds increases by more than 100 basis points in the same 12-month period.

The investment banking firm worried that the proposed 20-percent limit would actually inhibit the ability of bank portfolio managers to manage IRR. The investment banking firm also opined that proposed § 615.5132 would deprive the banks of sufficient liquidity during times of crisis, when the cost of System funds increases, and when the spreads between Farm Credit securities and United States Treasuries widen. The commenter noted that the net interest margins between the yield on earning assets and the cost of funds is narrower for the FCS banks than for commercial banks. According to information supplied by the investment banking firm, net margins for commercial banks have historically ranged from 300 to 400 basis points. Since the commenter contends that Farm Credit banks do not operate with the same profit motive as the private sector, net margins are 100 to 200 basis points narrower. The commenter argues that these compressed margins justify a limit of 50 percent of outstanding loans. From the perspective of the investment banking firm, proposed § 615.5132 exposes Farm Credit banks to margin compression, credit risk, and liquidity

crisis during periods of interest rate volatility since 80 percent of bank assets are allocated to agricultural loans.

C. FCA's Revisions to § 615.5132

After carefully considering all of these comments, the FCA now adopts final § 615.5132, which authorizes each Farm Credit bank to hold eligible investments, pursuant to § 615.5140, in an amount that does not exceed 30 percent of its total outstanding loans solely for the purposes of: (1) Maintaining a liquidity reserve pursuant to § 615.5134; (2) managing surplus short-term funds; and (3) managing interest rate risk pursuant to § 615.5135. In formulating the final regulation, the FCA accepted System recommendations to: (1) Increase the size of the investment portfolio from 20 to 30 percent; and (2) recognize IRR management, rather than IRR reduction, as a sound investment purpose.

For the reasons explained below, the FCA declines to add a provision to final § 615.5132 that would explicitly authorize Farm Credit banks to hold investments for the purpose of building capital. The FCA will respond to recommendations about the treatment of certain liabilities, such as Farm Credit investment bonds and CIPA in the preamble to the liquidity regulation, § 615.5134. Similarly, the FCA will address liquidity and IRR issues at length in the preambles to §§ 615.5134 and 615.5135 respectively.

The commenters have persuaded the FCA that System banks will be better able to manage their liquidity requirements, IRR, and surplus short-term funds if their investment level is 30 percent of their total outstanding loans.

In considering alternative approaches for final § 615.5132, the FCA carefully studied the options proposed by the commenters. All FCS commenters, except Farmer Mac, advised the FCA not to impose any regulatory restrictions on the size of bank investment portfolios. These commenters implied that this matter should be left to the discretion of the bank's board of directors. If this approach is followed through to its logical conclusion, any Farm Credit bank, at the discretion of its board, could hold most of its assets in investments that are unrelated to agricultural credit.

The FCA rejects this option because it is fundamentally incompatible with the charter, status, and purpose of the FCS. Congress enacted the Federal Farm Loan Act of 1916² after it concluded that commercial banks were unable to

furnish adequate credit to America's farmers on a sustainable basis.³ Congress acknowledged that its efforts to address the credit needs of farmers through the Federal Reserve Act of 1913 were largely unsuccessful, and agricultural credit was scarce because commercial banks primarily loaned money to borrowers who basically had different credit requirements than farmers.⁴ The cooperative Federal Land Bank System was established to ensure that farmers had a dependable, stable, and responsive source of credit.⁵ Although the scope of the FCS expanded over the years, its fundamental mission of meeting the credit needs of agricultural producers has never changed. In fact, section 1.1(a) of the Act declares that the policy of Congress is to promote a farmer-owned cooperative banking system that furnishes sound, adequate, and constructive credit to agricultural producers.

The FCA is also unable to reconcile the commenters' proposal with the FCS's cooperative principles.

Cooperatives, by law, conduct most of their business with their members, and earn most of their income from such transactions.⁶ From the FCA's perspective, a Farm Credit bank is not using its charter primarily to serve the credit needs of agricultural producers and rural communities once agricultural loans to its borrower-members no longer comprise a majority of its assets.

On the funding side of the equation, the commenters' proposal also conflicts with the GSE status of the FCS. Farm Credit banks borrow money on the capital markets to fund their assets. According to recent reports by the United States Treasury Department and the General Accounting Office (GAO), GSE status significantly enhances the creditworthiness of the FCS.⁷ Without GSE status, System banks would incur a substantially higher cost of funds.⁸ Under these circumstances, the FCA believes that it is inappropriate for System banks, as GSEs, to borrow funds

² See H.R. 630, 64th Cong., 1st Sess., (May 3, 1916), pp. 3-4. Also see S. Rep. 144, 64th Cong., 1st Sess. (Feb. 15, 1916) pp. 2-3.

³ *Id.*

⁴ *Id.*

⁵ Legal Phases of Farmer Cooperatives, United States Department of Agriculture, p. 4, 1976.

⁷ See Report of the Secretary of the Treasury on Government-Sponsored Enterprises, April, 1991, p. xxi. See also Government Accounting Office, Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks, May, 1991, pp. 18-19. See also Government Accounting Office, Government-Sponsored Enterprises: The Government's Exposure to Risk, August, 1990, pp. 83-89.

⁸ *Id.*

² Public Law 158, 64th Cong., 1st Sess., July 17, 1916.

at favorable rates, and then invest most of the money in assets other than agricultural loans.

The FCA interprets the Act and its legislative history as requiring each Farm Credit bank to hold a majority of its assets in agricultural loans. Pursuant to its authorities under sections 5.17(a)(4) and (9) of the Act, 12 U.S.C. 2252(a)(4) and (9),⁹ the FCA determines that a regulatory limit on investments ensures that Farm Credit banks abide by their: (1) Statutory mission of financing agriculture; and (2) cooperative principles. Accordingly, final § 615.5132 will impose a 30-percent limit on investments so that agricultural loans continue to comprise the majority of each FCS bank's assets.

Since an investment ceiling enforces compliance with the Act, the FCA rejects System arguments that only compelling safety and soundness reasons can justify restrictions on the size of bank investment portfolios. For the same reason, the FCA cannot accept the claim that an investment ceiling constitutes an unwarranted interference by the regulator in the business affairs of System banks.

System commenters also complained that an investment ceiling is unprecedented among GSEs and Federal regulators of financial institutions. In the FCA's opinion, this argument lacks merit because the FCS and these entities have fundamentally different missions, regulatory frameworks, funding mechanisms, and organizational structures. For example, commercial banks and credit unions are not legally required to furnish credit primarily to a specific economic sector. In the same context, commercial banks are predominantly stock corporations that do not operate under cooperative principles. Similarly, comparisons to other GSEs, such as the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), are not useful here because the FCS makes loans directly to borrowers, whereas the other two GSEs operate secondary markets that provide liquidity and credit enhancements to primary mortgage lenders.

However, a comparison between the FCS and the Federal Home Loan Bank (FHLB) System and its constituent savings associations has merit. FHLBs

make no retail loans. Instead, they lend to member savings associations and banks. See 12 U.S.C. 1421 *et seq.* A provision of the Federal Home Loan Bank Act, 12 U.S.C. 1431(h), authorizes FHLBs to invest only in obligations of the United States, securities backed by residential mortgages, and FNMA debt instruments. In contrast to the FCS, FHLBs are prohibited by statute from investing in any assets (except United States obligations) that are unrelated to their statutory mission of providing credit to primary residential mortgage lenders. Similarly, a comparison can be drawn between the FCS and savings associations because both are legally required to make most of their loans to specific types of borrowers. A provision in the Home Owners Loan Act (HOLA), 12 U.S.C. 1467a(m), mandates that all savings associations maintain "qualified thrift lender" status by holding at least 65 percent of their assets in home mortgages, securities backed by residential mortgages, FHLB stock, and other housing-related investments.

The FCA now responds to the Springfield banks' proposal that final § 615.5132 establish separate investment limits for loans that mature or reprice within 1 year, and fixed rate loans that have a longer term to maturity. This approach could, in effect, encourage all System banks to shift to a strategy where they would fund mostly short-term assets with short-term liabilities. The FCA is concerned that the resulting surge in short-term borrowings by the entire System could place substantial stress on the capital markets, which in turn, could widen the spread between FCS obligations and Treasury securities. Since amendments to § 615.5132 increase the investment level from 20 to 30 percent and authorize banks to manage IRR, the FCA believes that the final regulation should provide boards of directors with greater flexibility to devise funding strategies that meet the needs of their banks.

The investment banking firm advised the FCA to set the investment ceiling at 50 percent of loans, which would be suspended if: (1) Interest rates fluctuate by more than 200 basis points during the prior 12 months; or (2) cost of System funds increases by more than 100 basis points in the same 12-month period. After careful consideration, the FCA declines to adopt this commenter's recommendation. The FCA does not believe that the regulation should automatically suspend the regulatory cap on the size of bank investment portfolios if market rates rise, or the System's cost of funds increases by a certain percentage in a 12-month period.

Instead, the FCA adopts final § 615.5136, which empowers the FCA Board to waive or modify restrictions on the size of the investment portfolio and/or the liquidity reserve during times of economic or financial stress. The FCA prefers the flexibility of this approach which enables this agency to tailor a specific remedy for a particular problem. The FCA does not adopt the recommendation of the investment banking firm because it allows Farm Credit banks to shift most of their assets from agricultural loans to investments simply because interest rates rise above a certain threshold.

The FCA also denies the commenter's request to allow Farm Credit banks to hold investments in an amount that does not exceed 50 percent of their total outstanding loans. As noted earlier, the investment banking firm contends that this 50-percent investment-to-loan ratio margin is justified because Farm Credit banks have historically experienced narrower net interest margins than their commercial bank competitors. The FCA declines to adopt the investment banking firm's recommendation because investments have never approached 50 percent of loans at Farm Credit banks. Furthermore, no System commenter supported the position of the investment banking firm. Although no FCS commenter endorsed a regulatory limit on the size of bank investment portfolios, these commenters recommended, in the alternative, investment ceilings that were well below the 50 percent proposed by the investment banking firm.

As noted above, § 615.5132 will restrict the investment portfolios of each System bank to 30 percent of its outstanding loans. The FCA finds several justifications for this 30-percent level. First, all System commenters, except one, assured the FCA that an investment limit of 30 to 35 percent would provide management with sufficient flexibility to safely and soundly manage risks to bank liquidity or solvency. Second, the higher investment level recognizes that the balance sheets of System banks will be better diversified against risk for a one-industry lender, and will provide sufficient cushion for System banks to maintain adequate liquidity and manage IRR. Third, the higher level of investments should help stabilize earnings and will also provide higher quality assets to improve balance sheet credit risk. In this context, the FCA believes that final § 615.5132 will actually strengthen the ability of the FCS to finance agriculture because this 30-percent investment level should enable Farm Credit banks to better

⁹ Section 5.17(a)(4) of the Act authorizes the FCA to approve the issuance of System debt obligations under sections 4.2 (c) and (d) of the Act for the purpose of funding the authorized operations of FCS institutions. Section 5.17(a)(9) of the Act authorizes the FCA to prescribe rules and regulations that are necessary and appropriate for carrying out the Act.

withstand periodic stagnation in the agricultural economy.

Some commenters sought revisions to those provisions in § 615.5132 that restrict the investment activities of Farm Credit banks to specific purposes. As requested by the FCC and the Texas Bank, the FCA amended § 615.5132 so IRR management, rather than IRR reduction, is a purpose for System banks to hold investments. The FCA accepts the rationale of the Texas Bank that the effective management of IRR is a discipline, and that it could be prudent for a Farm Credit bank to increase IRR tolerances in certain scenarios. By authorizing FCBs, BCs, and ACBs, under § 615.5135, to manage their IRR with the use of investments, final § 615.5132 recognizes that IRR is one of the major risks in managing a financial institution because it impacts a major portion of net operating revenue.

In response to comments by the FCC and the Texas Bank, the FCA will now clarify its policy concerning the role of investments in building bank capital. The FCA has taken the position that the use of investments are essential for sound asset/liability management practices. Farm Credit banks could not maintain adequate liquidity, invest short-term surplus funds, or remain solvent in a constantly changing interest rate environment without liquid investments.

Investments and the income they generate help protect the viability of Farm Credit banks during times when the agricultural economy is in recession, or experiencing slow growth. However, the FCA believes, for the reasons discussed above, that Farm Credit banks should not use their GSE status to generate income from investments primarily for the purposes of building capital. Therefore, the FCA refuses requests to insert language in final § 615.5132 that would expressly recognize income generation and capital enhancement as a primary reason for Farm Credit banks to hold investments. Nevertheless, the FCA acknowledges that Farm Credit banks are likely to accumulate additional income and capital as an ancillary benefit of their compliance with the regulations in subpart E of part 615, which should improve their financial position.

IV. Investment Management

The FCA now adopts final § 615.5133, which governs investment management practices at System banks. The FCA adopted two minor revisions to this regulation in order to address concerns raised by the commenters.

Proposed § 615.5133 would require the board of directors of each FCB, BC,

and ACB to adopt a comprehensive written investment management policy that complies with the Act, FCA regulations, and other applicable provisions of law. While the FCA's proposal would expressly prohibit the board of directors from delegating its responsibility to supervise and review the bank's investment practices, the board would be responsible for ensuring that portfolio managers perform their duties in accordance with board policies. Board policies adopted under the proposed regulation should preclude investment management practices that expose the bank to excessive levels of risks. Proposed § 615.5133 would also require the board of directors of each Farm Credit bank to annually review: (1) Investment policies to determine whether current investment strategies are achieving portfolio objectives; and (2) the performance and quality of the investment portfolio.

Proposed § 615.5133 would require the investment policy of each bank to address, at a minimum, the following eight areas:

- (1) The purpose and objectives of the bank's investment portfolio;
- (2) Liquidity requirements pursuant to § 615.5134;
- (3) IRR management pursuant to § 615.5135;
- (4) Permissible brokers, dealers and institutions for investing bank funds pursuant to § 615.5140 and limitations on the amount of funds that may be invested or placed with any individual intermediary;
- (5) The size and quality of the investment portfolio;
- (6) Risk diversification;
- (7) Delegation of authority to manage investments to specific personnel and the scope of their authority; and
- (8) Internal controls to monitor the performance of the bank's investments and to prevent loss, fraud, embezzlement, and unauthorized activities.

Comments about proposed § 615.5133 were received from the FCC, a BC, an FCB, and the ABA. The other System commenters either endorsed the FCC's position, or offered no opinion about proposed § 615.5133.

The ABA urged the FCA to adopt proposed § 615.5133 as a final regulation. This commenter believes that the FCA's proposal establishes proper board of director control over the investment operations at Farm Credit banks. According to the commenter, commercial banks operate under similar requirements.

The FCB expressed general support for proposed § 615.5133, but it opposed

the provision that would require "System banks to place a specific dollar limit on liquidity investments that would cause such investments to be limited to 15 days of coverage." This comment apparently reflects the bank's opposition to a passage in the preamble to the proposed regulation which interpreted § 615.5133(b) as requiring board policy to identify those investments that are held in the liquidity reserve. See 56 FR 65691, 65693 (December 18, 1991). Although the FCA defers substantive discussion about the liquidity reserve requirement until the preamble to final § 615.5134, it still adheres to its position that § 615.5133(b) mandates bank board policies to identify those investments free of lien, that are held for liquidity management.

The FCC concurred that boards of directors are responsible for: (1) Adopting comprehensive investment policies; and (2) ensuring that portfolio managers conduct the bank's investment operations in accordance with such policies. The commenter also endorsed the eight broad areas that proposed § 615.5133 would require bank boards to address in an acceptable investment policy. The FCC, however, sought modifications to certain provisions in the proposed regulation.

The FCC requested clarification of the sentence that prohibits the board of directors from delegating its responsibility to supervise and review the bank's investment practices. The commenter asserted that the term "supervise" connotes day-to-day management. Accordingly, the commenter recommended that the FCA clarify this provision by substituting the term "monitor" for "supervise."

In response, the FCA agrees that § 615.5133 requires boards of directors to oversee, rather than to engage in day-to-day management, of their banks' investment activities. However, the FCA emphasizes that portfolio managers must, at all times, operate under the direction of the board, and adhere to board policies pertaining to investment operations. Similarly, boards of directors bear responsibility under § 615.5133 for enforcing compliance with its written policies.

The FCA has occasionally detected situations at some Farm Credit banks where portfolio managers have engaged in investment transactions without clear authority, and then sought ratification from the board of directors. One of the purposes of § 615.5133 is to prevent such practices. For this reason, the FCA believes that the term "monitor" does not adequately convey the intent of this regulation. Instead, the final regulation

will prohibit board of directors from delegating their responsibility to oversee and review their banks' investment practices.

The FCC also objected to a provision in proposed § 615.5133(d) that would require boards of directors to establish the amount of funds that portfolio managers are authorized to invest or place with individual brokers, dealers, or financial institutions. The commenter asserted that the board of directors should review, but not approve investment decisions made by management. Instead, the FCC believes the board should approve the overall policy that guides management in: (1) Selecting brokers, dealers, and financial institutions; and (2) establishing limits on individual investments. The commenter compared the requirements in proposed § 615.5133(d) to a hypothetical situation where bank boards would approve all individual loans originated in their Farm Credit district.

One BC commenter joined the FCC in opposition to proposed § 615.5133(d). This commenter argued that the board of directors should establish credit policy and delegate its administration to management. According to the BC's interpretation of proposed § 615.5133(d), the board of directors would be required to independently judge the creditworthiness of each institution where bank funds would be invested or placed.

The FCA responds that the board of directors, not the portfolio managers, bear ultimate responsibility for bank solvency. For this reason, § 615.5133(d) places the burden on the board of each Farm Credit bank to develop and implement appropriate policies that ensure that: (1) Bank funds are only placed through solvent brokers, dealers, and financial institutions; and (2) investment portfolios are diversified to minimize loss exposure. In this context, the board of directors must affirmatively guide the bank's investment activities, rather than passively review and "rubber stamp" investment decisions of portfolio managers.

The FCA's policy on this issue is consistent with the position of other Federal financial institutions regulators. According to a policy statement released by the Federal Financial Institutions Examination Council (FFIEC), the board of directors of commercial banks, savings associations, and credit unions are now required to periodically review and approve: (1) Lists of securities firms with whom portfolio managers are authorized to do business; and (2) limits on the amounts and types of transaction to be executed with each authorized

securities firm. See 57 FR 4028, 4034 (February 3, 1992).

The FCA now explains its reasons for requiring board approval of specific brokers, dealers, and financial institutions. Frequently, small and remote depository institutions or securities firms offer attractive rates to potential investors. Information about the financial stability of these institutions can be scarce, inaccurate, incomplete, or outdated. Furthermore, a Farm Credit bank may have little knowledge of, and no investment experience with the party who is soliciting its funds. These investments may offer investors a higher rate of return because they entail a higher degree of risk. Under these circumstances, careful and deliberate investigation, research, and analysis should be conducted before the bank purchases such investments. By requiring portfolio managers to invest only through pre-approved brokers, dealers, and financial institutions, this regulation precludes hasty investment decisions that increase the risk of loss to the bank. Additionally, bank investment officers are sheltered from pressure by sales representatives of parties who are not authorized to engage in investment transactions with the bank.

The comment letters of the FCC and the BC indicate confusion in the FCS about the ambit of § 615.5133(d), and therefore, the FCA seeks to clarify the requirements of this provision. Contrary to the BC's comment, § 615.5133(d) envisions that portfolio managers will assist the board of directors in selecting brokers, dealers, and financial institutions where bank funds will be invested or placed. Bank directors may rely on information supplied by portfolio managers, nationally recognized credit rating services, and other credible sources, in ascertaining the creditworthiness of potential counterparties in investment transactions. Section 615.5133(d) does not preclude portfolio managers from recommending securities firms and financial institutions, or otherwise consulting with the board about such matters. Instead, the regulation prohibits the board of directors from delegating its ultimate responsibility to ensure that bank funds are invested solely through solvent parties, and that the investment portfolio is diversified.

Similarly, § 615.5133(d) does not require the board of directors to approve each and every investment transaction. Instead, the regulation requires board policy to establish broad parameters under which portfolio managers will conduct the bank's investment

operations on a daily basis. Thus, the board will approve securities firms and financial institutions where bank funds may be invested or placed, and it will impose a maximum limit on transactions with each party, but the portfolio managers will select, purchase, manage, monitor, and sell individual investments.

Finally, the FCA is adding a new paragraph (i) to final § 615.5133, which requires the board of directors of each FCB, BC, or ACB to establish policies governing investments in mortgage-related securities and asset-backed securities pursuant to final §§ 615.5140(a)(2) and 615.5140(a)(8)(ii) of this subpart. Section 615.5133(i) requires a board policy to address such issues as maximum exposure to the MBS category, minimum pool sizes, number of loans in a pool, geographic diversity of pools, and maximum allowable premiums to be paid. This new provision is necessary because the FCA, in response to the FCC and the investment firm, significantly expanded the authorities of System banks to invest in mortgage-related securities under § 615.5140(a)(2) and asset-backed securities under § 615.5140(a)(8)(ii). The preamble to §§ 615.5140(a)(2) and 615.5140(a)(8)(ii) will explain these new authorities in greater detail.

V. Liquidity Reserve Requirement

A. The FCA's Original Proposal on Liquidity

On December 18, 1991, the FCA proposed a regulation that, for the first time, would establish a fixed liquidity reserve requirement for all FCS banks. The proposed regulation would have required all Farm Credit banks to maintain a liquidity reserve sufficient to fund their operations for approximately 15 days. More specifically, proposed § 615.5134(a) contained a formula that would require each FCB, BC, and ACB to maintain a liquidity reserve to fund: (1) Fifty (50) percent of its bonds and interest due within the next 90 days divided by 3; and (2) fifty (50) percent of discount notes due within the next 30 days. This provision would have also required each Farm Credit bank to calculate its liquidity reserve requirement as of the last calendar day of March, June, September, and December, based upon the average daily balance of outstanding loans during the same quarter. Proposed § 615.5134(b) would have prohibited Farm Credit banks from maintaining liquidity reserves in excess of authorized requirements unless the FCA Board modified or waived the requirement during an agricultural, economic,

financial, or national defense emergency.

The preamble to proposed § 615.5134 explained the FCA's policy on the role of liquidity in the FCS. The FCA noted that liquidity is based upon the ability to fund assets and pay liabilities. Since the Farm Credit System is funded through the sale of debt obligations, the liquidity of Farm Credit banks depends largely upon daily access to money and capital markets. In the event that access to these money and capital markets is totally or partially denied during a crisis, Farm Credit banks draw upon their liquidity reserve, which is an emergency source of funds, in order to meet their short-term funding needs.

Historically, the level of liquidity in the FCS and the demand for System obligations in the money and capital markets has been influenced by the Federal Reserve Board, the United States Treasury, and external economic events. If investor confidence in Systemwide obligations erodes during a crisis, Farm Credit banks can experience difficulty raising funds in the money and capital markets. As a result, System banks will be compelled to offer investors a higher rate of return in order to attract capital. This, in turn, could cause interest rate spreads relative to Treasuries to widen. When this situation occurs, Farm Credit banks generally increase their liquidity reserve so that they will be able to fund their operations for an extended period of time, if their access to the money and capital markets becomes impeded.

Conversely, several studies that the FCS conducted since 1975 determined that Farm Credit banks should maintain a minimum liquidity reserve to fund their operations for approximately 15 days when the basis point spreads to comparable maturity United States Treasuries are near their historical levels. Accordingly, System banks, acting in concert through the Board of Directors of the Federal Farm Credit Banks Funding Corporation, devised a formula that requires all FCBs, BCs, and ACBs, at a minimum, to maintain sufficient liquidity to fund a portion of their maturing obligations, interest payments, and discount notes for the next 15 days.

As noted in the preamble to the proposed regulation, most Farm Credit banks exceed this minimum liquidity requirement, on average, by at least 1.4 times, while the liquidity at some banks is between 2 and 5 times above this requirement. Although Farm Credit banks have attempted to justify these investment levels, the FCA criticized this practice in the preamble to the proposed regulation. See 56 FR 65691,

65694 (December 18, 1991). More specifically, the FCA questioned whether FCS banks should use their GSE status to build and maintain an investment portfolio for the purpose of generating additional income. The FCA also objected to the practice of issuing short-term debt obligations to fund current operations. The FCA noted that this practice actually increases the bank's short-term debt load, and thus increases the amount of liquidity that a bank must maintain in order to meet the minimum Systemwide liquidity requirement.

B. The Comments

The liquidity component was the most controversial part of the proposed investment regulations. The FCC and two FCBs opposed the FCA's position while the ABA supported it. Other Farm Credit banks endorsed the FCC's position, while the investment banking firm offered no opinion about proposed § 615.5134.

The FCC stated that the FCA's approach toward liquidity lacks flexibility. The commenter notes that liquidity "is an ever present basic and paramount risk for any bank," and that there is direct relationship between inadequate liquidity and insolvency. The commenter further asserts that during times of financial stress, both bank management and the FCA are powerless to stop investor flight that will cause illiquidity in the FCS. The FCC complains that the proposed regulation wrongfully assumes that the FCS will always have access to financial markets "under all circumstances and for whatever amounts and maturities may be required." In this context, the FCC argues that the 15-day liquidity reserve requirement in proposed § 615.5134 is inadequate and imprudent.

The FCC also expressed misgivings about the provision in proposed § 615.5134 which would enable the FCA to modify the liquidity level whenever a financial, economic, agricultural, or national defense crisis impedes the FCS's access to the capital markets. The commenter contends that the FCA cannot accurately forecast such crises until well after the fact. From the commenter's perspective, once System access to the markets is disrupted, the FCA will be unable to preempt funding problems at System banks by belatedly allowing the banks to increase their liquidity reserves.

The FCC observed that the 15-day fixed liquidity requirement of § 615.5134 would be subject to § 615.5132, which restricts the size and purpose of each bank's investment

portfolio. The commenter noted that once a System bank complied with its liquidity reserve requirement by allocating certain investments to retire liabilities maturing in the next 15 days, it could manage IRR and short-term surplus funds with other investments, so long as the investment portfolio did not exceed 20 percent (now 30 percent) of its total outstanding loans. In this context, the commenter stated that the FCA's proposal precludes System banks from adopting a strategy of funding their operations primarily with short-term debt. Since a short-term funded bank needs a large pool of liquid assets in order to retire its maturing liabilities and pay operating expenses, the commenter expressed concern that §§ 615.5132 and 615.5134 will compel such a bank to allocate most or all of its investment portfolio toward its liquidity reserve requirement. As a result, a short-term funded bank may not be able to effectively manage its IRR or short-term surplus funds because the amount of investments allotted to the liquidity reserve may approach 20 percent of the bank's total outstanding loans. The commenter argues that the FCA's approach deprives FCS banks of flexibility to establish their own asset/liability management (ALM) strategy.

Since the FCC believes that access to the financial and capital markets is wholly unpredictable, it advises the FCA to adopt a final regulation that encourages System banks to constantly build more liquidity as protection against potential market disruptions. The commenter suggests that final § 615.5134 should establish a minimum liquidity reserve requirement of 15 days while allowing each bank's board of directors to determine the maximum liquidity level "consistent with [its] unique circumstances." Additionally, the FCC petitioned the FCA to adopt a final regulation that exempts the liquidity reserve requirement from the investment ceiling in § 615.5132.

The FCC also recommends several revisions to the formula for calculating the liquidity reserve requirement. First, the commenter suggests that the final regulation enable System banks to include actual cash needs in their calculation of their liquidity reserve requirement. In the FCC's view, cash needs include expected loan volume changes and other operational needs of the bank. Second, the FCC objected that System debt obligations are the only liabilities that the proposed regulation authorizes Farm Credit banks to include in their liquidity reserve calculations. The commenter suggests that the FCA amend § 615.5134(a) so that FCS banks can include other debt, such as Federal

funds purchased, stockholder debt, repurchase agreements, and commercial bank borrowings, in the calculation of their liquidity reserve. Third, the FCC advises the FCA to exclude investments which are pledged as collateral or restricted by contract (i.e. CIPA) from both the liquidity reserve requirement and the overall ceiling on investments. Fourth, the commenter requests that the final regulation require Farm Credit banks to calculate their liquidity reserve requirement at least monthly using month-end data.

The Texas Bank endorsed the FCC's position that the minimum liquidity reserve requirement should be established by FCA regulation, while the maximum liquidity reserve level of each Farm Credit bank would be determined solely by its board of directors. However, the commenter also proposed a compromise to bridge the positions of the FCA and System banks. Under the Texas Bank's alternative, the final regulation would establish a fixed liquidity reserve requirement of 30 days. This compromise would incorporate the FCC's proposal to revise the formula for calculating each bank's liquidity reserve requirement.

The Columbia Bank expressed strong opposition to proposed § 615.5134. This commenter asserted that the FCA's proposed liquidity regulation is "premised on a misunderstanding of the role of liquidity in the prudent, safe and sound management of System Banks." According to the Columbia Bank, the FCA fails to comprehend that liquidity is a primary mechanism for System banks to maintain stable income. The commenter contends that narrow spreads between System debt obligations and United States Treasury issues, in large measure, reflect investor confidence in the FCS when it generates consistent and stable earnings and return on capital. The spread between FCS debt obligations and Treasuries widens when the capital and financial markets perceive deterioration in the stable earnings and income of System banks.

In this context, the Columbia Bank notes that additional liquidity enables Farm Credit banks to offset adverse spreads between System debt obligations and United States Treasury issues. Accordingly, the commenter does not view the liquidity reserve solely as an emergency source of funds. Instead, the Columbia Bank relies on liquid investments to hedge against potential increases in the cost of System funds. Under this strategy, the bank can, in its discretion, pay operating expenses and retire maturing debt by selling liquid investments instead of issuing

new debt obligations in the financial markets.

The Columbia Bank disputes FCA's contention that Farm Credit banks will abuse their GSE status by arbitraging the financial markets with their excess liquidity. This commenter claims that today's sophisticated and diversified financial markets offer Farm Credit banks no incentive to engage in arbitrage activities. The Columbia Bank argues that the FCA has adequate enforcement powers under title V of the Act to discipline any bank that arbitrages the financial markets.

The Columbia Bank recommends that final § 615.5134 require all System banks to maintain sufficient liquidity to fund their operations for no less than 15 days, but no more than 90 days. Under the commenter's proposal, a System bank that maintained a 90-day liquidity reserve could not hold an investment portfolio that exceeds 35 percent of total outstanding loans.

In contrast, the ABA praised the FCA's proposal as well crafted and balanced. From the ABA's perspective, the proposed regulations promote portfolio diversification and effective risk management at FCS banks. The commenter also opined that proposed § 615.5134 would ensure that FCS banks always maintain adequate liquidity, during both normal economic times and periods of economic and financial stress.

The ABA expressed concern that many FCS banks use investments "primarily for the purpose of increasing earnings rather than providing liquidity." The commenter complained that excess liquidity in the FCS results in abuse of GSE status. The ABA concurred with the FCA's observation that the practice of issuing short-term discount notes to fund operations actually increases the debt load of System banks, which in turn increases their need for additional liquidity. In the commenter's opinion, these short-term discount notes are "acting as the functional equivalents of deposit taking and check clearing operations." The ABA also complained that System banks channel their earnings from investments into risky "extraneous activities," instead of agriculture. The commenter concluded that proposed § 615.5134 would end these practices while enhancing the safety and soundness of the FCS.

C. FCA's Revisions to § 615.5134

The FCA continues to adhere to its original position that Farm Credit banks should maintain sufficient liquidity to fund their maturing debt and interest obligations for approximately the next

15 days, except during times of crisis when this agency shall authorize System banks to increase their liquidity reserves and/or the size of their investment portfolios. As requested by the FCC, the FCA has modified this regulation so that Farm Credit banks are required to calculate their liquidity reserve requirement on a monthly basis utilizing month-end data. Furthermore, the final regulation shall authorize Farm Credit banks to include cash, commercial bank borrowing, and shareholder investment bonds in their liquidity reserve calculation.

The FCA emphasizes that the liquidity reserve is an emergency source of funds that Farm Credit banks draw upon solely for the purpose of retiring maturing debt obligations, making current interest payments, and paying operating expenses, whenever their access to capital and financial markets is impeded as a result of a financial, economic, agricultural, or national defense crisis.

The FCA's policy contrasts sharply with the position of System commenters who assert that § 615.5134 should authorize FCS banks to use their liquidity reserves for other functions besides emergency funding. As already discussed, some Farm Credit banks issue short-term obligations to fund their current operations. This short-term funding strategy requires such banks to increase their liquidity needs in order to service their increased short-term debt load. Other FCS banks hedge against potential increases in the cost of funding FCS debt obligations by building investment portfolios that could be used to bypass the financial and capital markets.

These practices cause most Farm Credit banks to exceed the 15-day liquidity reserve requirement that the FCS banks established through the auspices of the Federal Farm Credit Banks Funding Corporation. System commenters oppose the FCA's efforts to incorporate a 15-day liquidity reserve requirement into this regulation because it would effectively require Farm Credit banks to use their liquidity reserves solely as an emergency source of funds. For this reason, System commenters petitioned the FCA to expand the size of the liquidity reserve in § 615.5134. While the FCC and two FCBs offered various alternatives to the FCA, no commenter repudiated the premise in several System studies that Farm Credit banks require a liquidity reserve to fund their operations for approximately the next 15 days, during stable economic times, when the basis point spreads between Systemwide debt obligations and comparable maturity United States

Treasury issues are near their historical levels.

From the FCA's viewpoint, Farm Credit banks can accomplish their other ALM objectives without drawing down their liquidity reserves. For example, Farm Credit banks could rely on investments held for IRR management, not liquidity, to address their exposure to basis risk, which is caused by fluctuations in the spread between System debt and competitive market securities or indicies. The FCA notes that basis risk is a form of IRR. Basis risk exposures should be addressed in loan pricing mechanisms that incorporate premiums to ensure profitability objectives are met. From FCA's perspective, Farm Credit banks should strive to manage basis risk in a disciplined manner rather than tapping into their liquidity reserve.

The FCC claims that Farm Credit banks should perpetually build their liquidity reserves to protect themselves against any potential market disruption. The FCC's approach may allow System banks to accumulate large portfolios of liquid investments during stable economic times when the spread between FCS debt obligations and Treasuries is narrow. Within time, FCS banks would accumulate large liquidity reserves that, in all likelihood, would disproportionately exceed their need for funds in the event that System access to money markets becomes impeded.

The FCA reaffirms its basic position that the practice of buying investments solely to generate additional income is not compatible with GSE status. The mission of the FCS is to finance agriculture and other specified rural credit needs. Since the FCS operates on cooperative principles, loans to member-borrowers are supposed to be the primary source of income to Farm Credit institutions. As the FCA has previously stated, investments are ALM tools to combat risks to bank solvency and liquidity.

The United States Budget for fiscal year 1992 contained a section that focused on the role of GSEs in providing credit to specific sectors of the American economy, and the financial risk they pose to the Federal government. As part of its budget review, the Office of Management and Budget (OMB) identified specific risks that each GSE poses to the United States Treasury, and it proposed reforms to reduce these risks. The following passage from the budget articulates the OMB's position:

A System-wide standard for sound asset/liability management should be adopted. . . . Liquidity guidelines for FCS institutions should be clarified and enforced. Currently,

the FCS has \$51 billion in outstanding loans and well over \$54 billion in outstanding debt. Some institutions have over 400 percent of the liquidity required by the Funding Corporation. . . . This implies that some institutions are creating arbitrage profits from the issuance of federally backed FCS debt.¹⁰

Clearly, FCA is not the only governmental agency concerned about FCS institutions' ability to arbitrage profits from the issuance of FCS debt, which is implicitly backed by the United States.

The FCA does not agree with the Columbia Bank's claim that liquidity is a primary mechanism for System banks to maintain stable earnings and return on capital, which in turn, inspires investor confidence in FCS bonds. Instead, the FCA notes that the competent management of agricultural and rural development loans should generate the earnings and returns on capital which inspire investor confidence in FCS obligations.

Accordingly, the FCA retains in final § 615.5134 a provision that requires all FCS banks to maintain a liquidity reserve sufficient to fund their operations for approximately the next 15 days. Furthermore, final § 615.5134 shall not exempt the liquidity reserve from the provision in § 615.5132 that restricts overall investments of each bank to 30 percent of its total outstanding loans.

The FCA has revised § 615.5134 so that the final regulation reinforces the concept that the liquidity reserve shall only be used as an emergency source of funds. As a result, final § 615.5134(b) shall now require each FCB, BC, and ACB to segregate investments held for liquidity from investments that are maintained for the management of IRR and short-term funds. Furthermore, final § 615.5134 shall only authorize Farm Credit banks to hold investments that are unencumbered by (free of) lien in their liquidity reserve.

Since commenters have expressed concern that the liquidity reserve formula is inflexible, the FCA now explains its approach towards enforcing § 615.5134. As noted earlier, the FCA expects Farm Credit banks to maintain a liquidity reserve that is sufficient to fund their operations for approximately 15 days. Every month, Farm Credit banks shall calculate the amount of debt that will mature within the time period prescribed by § 615.5134. This calculation determines the size of the liquidity reserve at each bank. The FCA recognizes that the size of the liquidity reserve shall fluctuate from one month

to the next. FCA examiners shall exercise discretion so that Farm Credit banks will not be subject to criticism when the value of the assets held in the liquidity reserve periodically varies from the value prescribed by § 615.5134 due to the timing and deliberations required for the purchase and sale of assets and liabilities.

If a financial, economic, agricultural, or national defense crisis disrupts the capital and financial markets that provide funds for the FCS, the FCA shall waive or modify the liquidity reserve requirement by resolution of the FCA Board. Despite FCC concerns, the FCA is confident that it will be able to respond expeditiously to a crisis. The FCA constantly monitors the financial conditions of the FCS, as well as the economic environment in which it operates. Similarly, System banks and the Federal Farm Credit Banks Funding Corporation can petition the FCA to increase or waive the liquidity reserve requirement if they believe that their access to the money markets may become impeded. The FCA redesignates proposed § 615.5134(c) as final § 615.5136. In order to provide the FCA with greater flexibility in an emergency, final § 615.5136 also authorizes the FCA Board to increase the size of the investment portfolio.

As requested by the FCC, the FCA adjusts the formula in § 615.5134(a) for calculating the liquidity reserve requirement to include Farm Credit Investment Bonds within the liquidity reserve formula by amending § 615.5134(a)(1), which establishes the liquidity calculation for bonds, notes, and interest. Farm Credit investment bonds are debt obligations of individual banks that are sold directly to borrower/shareholders rather than through brokers and dealers. Furthermore, a new provision in the final regulation, § 615.5134(a)(3), requires each FCB, BC, and ACB to maintain liquidity sufficient to fund 50 percent of its commercial bank borrowing due within the next 30 days. These two revisions to § 615.5134(a) are justified because section 4.2(a) of the Act clearly contemplates that Farm Credit banks shall fund their operations by: (1) Issuing debt obligations; and (2) borrowing from commercial banks.

The FCA is amending § 615.5134 so that the final regulation permits FCS banks to include cash in their liquidity reserve. Conversely, the FCA declines the FCC's request to include Federal funds purchased, repurchase agreements, and similar instruments in the liquidity reserve formula because section 4.2 of the Act does not recognize

¹⁰ Budget of the United States Government for fiscal year 1992; Part Two, p. 241.

these instruments as a source of FCS funding.

The FCA denies the FCC's request to exclude assets pledged under CIPA from both the liquidity reserve requirement in § 615.5134 and the overall investment ceiling in § 615.5132. CIPA requires Farm Credit banks that fail to comply with certain contractually agreed upon performance standards to establish a segregated account that consists entirely of United States government securities. CIPA forbids Farm Credit banks from drawing upon these segregated assets for current operational purposes. Accordingly, these instruments would not be available for use in a liquidity reserve.

The FCA revises § 615.5134 to require Farm Credit banks to calculate their liquidity reserve requirements monthly, rather than quarterly. This revision should enable System banks to more accurately gauge their liquidity needs.

VI. Management of Interest Rate Risk

The FCA proposed a new regulation, § 615.5135, which for the first time, identified IRR reduction as an authorized reason for holding investments for System banks. From the FCA's perspective, the effective management of IRR is among the most difficult and important challenges facing boards of directors and bank managers. Interest rate volatility can undermine the solvency of Farm Credit banks. Sudden interest rate fluctuations may significantly impact the NII and market value of equity (MVE) of Farm Credit banks. Accordingly, the FCA sought to ensure bank managers measure the impact of changing interest rates on their balance sheets so they could devise an effective investment strategy to insulate the bank from excessive IRR.

In this context, the FCA reasoned that interest rate shock tests enable bank management to gauge the bank's exposure to IRR on a continual basis, and understand its impact on NII and MVE over extended periods of time. The proposed regulation would have incorporated a provision of the FCA's current policy statement on IRR management,¹¹ which encourages System banks to simulate the impact of an instantaneous and sustained 200-basis-points (interest rate shock or shocking) increase and decrease in interest rates on its projected NII and MVE.

As proposed by the FCA, § 615.5135(a) would require the board of directors of each bank to adopt IRR

management sections under ALM policies which establish IRR exposure limits. Under proposed § 615.5135(b), all FCBs, BCs, and ACBs would simulate, on a quarterly basis, the impact of an instantaneous and sustained 200-basis-points increase and decrease in interest rates over the next 12 months on the bank's NII and MVE. Proposed § 615.5135(c) would require each Farm Credit bank to develop, at least every quarter, the following three projections of the impact of interest rate changes on the bank's NII and MVE: (1) A best case scenario; (2) a worst case scenario; and (3) a most likely case scenario. Section 615.5135(d) of the proposed regulation would authorize Farm Credit banks to purchase and hold the eligible investments listed in § 615.5140 of this subpart in order to reduce IRR resulting from the bank's normal lending operations. Under the FCA's proposal, each bank would be required to document, prior to purchase, the reasons why a particular investment is needed to meet IRR objectives. Furthermore, the proposed regulation would require subsequent quarterly reports which indicate whether such investments are satisfying the IRR objectives of the bank.

The FCC and two FCBs commented on proposed § 615.5135. The other FCS commenters endorsed the FCC's position, while the two non-System commenters refrained from commenting on § 615.5135. As noted in the preamble to final § 615.5132, the FCC and one FCB recommended that the FCA amend § 615.5135 so it mandated the management, rather than the reduction of IRR.

Although the FCC did not fundamentally oppose proposed § 615.5135, it perceived some provisions of the regulation as prescribing management practices rather than promoting safety and soundness. While the FCC acknowledged that the FCA, as a safety and soundness regulator, has the responsibility to fully examine ALM processes at all Farm Credit banks, it asserted that the agency should not prescribe specific methods and procedures for measuring IRR. The commenter warned that proposed § 615.5135 would not necessarily provide the most accurate gauge of IRR at a System bank at a particular point in time.

Accordingly, the FCC advocated an alternative approach that would require each bank to determine the most appropriate methods for measuring the level of IRR in its portfolio. In this context, the commenter recommended an amendment to § 615.5135(a) that would require each System bank to

establish the criteria for determining compliance with the IRR exposure limits of its ALM policy. The FCC asserted that its approach was less rigid and more insightful than the proposed regulation because it would enable the FCA to evaluate the risk measurement processes of all FCS banks, and to hold each bank accountable for supporting its method and conclusions.

The FCC did not oppose the quarterly 200-basis-point shock tests of proposed § 615.5135(b), but it urged the FCA to delete proposed § 615.5135(c), which would require all Farm Credit banks to develop quarterly projections of a best case, a worst case, and a most likely case scenarios concerning the impact of interest rate fluctuations on NII and MVE during the next 12 months. The FCC opined that proposed § 615.5135(c) "is ambiguous and probably not very informative." Since the commenter doubted that these three selected scenarios would realistically reflect actual future movements in interest rates, it claimed that System banks would derive little benefit from conducting the analysis required by proposed § 615.5135(c).

The FCC also opposed those provisions in § 615.5135(d) that would require each System bank to evaluate in writing, both before and after purchase, how a selected investment achieves its IRR objectives. The commenter asserted that these matters are managerial disciplines that fall exclusively within the purview of the board and management, and therefore, they do not warrant detailed procedural instructions in a regulation. The FCC also proposed a technical amendment to the first sentence in proposed § 615.5135(d), which would authorize Farm Credit banks to hold eligible investments in order to reduce IRR resulting from their normal "lending" operations. The commenter advised the FCA to delete the term "lending" from § 615.5135(d) because the regulation focuses on IRR that results from all operations at System banks.

A FCB concurred with the FCC that proposed § 615.5135 would shift FCA regulation from general oversight toward detailed bank management. This commenter complained that the proposed regulation would impose extremely burdensome documentation requirements on System banks concerning IRR management. Since the commenter claimed that the costs of proposed § 615.5135 outweighed its benefits, it urged the FCA to eliminate or substantially reduce the paperwork and simulation requirements of this regulation.

¹¹ See booklet 281-OE (January 15, 1991) Re: Asset/Liability Management Practices.

Furthermore, this FCB viewed proposed § 615.5135 as impractical because liquidity maintenance and IRR management are often so closely related that it may be difficult, if not impossible, to separate the purposes behind a particular investment transaction. This commenter felt that evaluating each investment transaction to meet specific interest rate sensitivities used in the process of managing IRR imposed micro-level evaluation. This FCB warned FCA that FCS banks may not be able to meaningfully isolate IRR management functions of individual investments.

The commenters have persuaded the FCA to modify § 615.5135 so it provides System banks with more flexibility to resolve their IRR exposure within established safety and soundness parameters. As a result, the final regulation permits FCBs, BCs, and ACBs to "manage" rather than "reduce" IRR. Moreover, while final § 615.5135 sets forth fundamental safety and soundness criteria for IRR management, it no longer dictates detailed management practices to System banks.

As noted earlier, the FCA has amended §§ 615.5132 and 615.5135 so that the final regulations require FCS banks to "manage" rather than "reduce" IRR. The regulations in subpart E of part 615 require bank management to establish a framework of policies, procedures, controls, and reporting practices for safeguarding the solvency and liquidity of the bank. In this context, these practices should effectively help an institution manage its IRR, not necessarily reduce it. Reduction of IRR may be the result of managing IRR, but it may not always be the sole objective of the bank. In certain scenarios, it may be prudent for a Farm Credit bank to increase its IRR tolerance levels. By amending this regulation, the FCA is providing System banks with greater flexibility to combat their exposure to IRR.

System commenters suggested that the FCA could ensure that Farm Credit banks safely and soundly manage IRR without prescribing specific methods and procedures for measuring IRR exposure in § 615.5135. In response, the FCA acknowledges that a more flexible regulatory approach will permit System banks to incorporate other IRR strategies into their ALM practices. Since the FCA agrees with the commenters that other risk evaluation techniques may also effectively assist bank managers in their task of managing IRR, the FCA now adopts the FCC's proposed amendment to § 615.5135 which will enable each System bank to establish criteria for

determining compliance with the IRR exposure limits of its ALM policy.

In crafting final § 615.5135, the FCA sought to balance the banks' need for managerial flexibility in containing IRR in their balance sheets with the agency's responsibility to ensure that all FCS institutions operate safely and soundly. For this reason, the final regulation requires each System bank to comply with certain criteria when it develops and implements an IRR management section to its ALM policy. From the FCA's perspective, final § 615.5135 establishes the minimum requirements necessary to ensure that: (1) Farm Credit banks manage their IRR in a safe and sound manner; and (2) the FCA is able to discharge its responsibility to effectively examine the ALM practices at System banks for safety and soundness.

Under final § 615.5135, each System bank shall, at a minimum, address five specific areas in the IRR management section of its ALM policy. Under § 615.5135(a), each bank shall identify and analyze the causes of risks within its existing balance sheet structure. Section 615.5135(b) requires System banks to measure the potential impact of these risks on projected earnings and market values by conducting interest rate shock tests and simulations of multiple economic scenarios at least on a quarterly basis. Although § 615.5135 continues to require Farm Credit banks to perform interest rate shock tests and develop simulations of multiple economic scenarios, it no longer specifies exact tests and simulation models. Instead, the IRR management section of each bank's ALM policy shall identify the shock tests and simulations that the bank shall use to measure its IRR exposure. System banks are required by § 615.5135(c) to explore and implement actions needed to obtain its desired risk management objectives.

Final § 615.5135(d) states that a System bank shall document the objectives it is attempting to achieve by purchasing eligible investments, while § 615.5135(e) requires quarterly evaluation and documentation to determine whether these investments have actually met the bank's objectives. The FCA emphasizes that final § 615.5135(d) and (e) do not require System banks to document, before and after purchase, how each individual investment transaction in an investment position performed in managing a specific IRR exposure. Instead, these provisions only require a bank to evaluate and document the performance of a block of investments that was acquired to manage a specific IRR exposure.

Finally, the FCA addresses the FCB's complaint that it is difficult to separate the investment purposes supporting a particular investment transaction. The FCA does not agree with this point of view. The regulations in subpart E of part 615 authorize Farm Credit banks to hold investments solely for the purposes of maintaining a liquidity reserve and managing IRR and short-term surplus funds. Furthermore, these regulations accord different treatments for investments held for IRR and liquidity. Section 615.5134 requires FCS banks to segregate investments that are held in the liquidity reserve. Conversely, Farm Credit banks must comply with the evaluative process set forth in final § 615.5135 for investments that are held to manage IRR. Since these regulations require each bank to identify whether an investment is used for liquidity or IRR management, the same investment cannot simultaneously be used for both purposes.

VII. Eligible Investments

Final § 615.5140 expands the list of eligible investments that Farm Credit banks are authorized to hold in order to comply with the requirements of § 615.5132 pertaining to liquidity, IRR, and the investment of surplus short-term funds. As the FCA noted in the preamble to the proposed regulation, only investments that can be promptly converted into cash on an established secondary market are suitable for liquidity, IRR management, and the investment of surplus short-term funds. See 56 FR 65691, 65695 (December 18, 1991). Therefore, all eligible investments listed in final § 615.5140 share the following characteristics: (1) Short-term maturities or short-term repricing mechanism; (2) a high investment grade credit rating by a nationally recognized credit rating service; (3) an active and universally recognized secondary market exists for trading these investments; and (4) these investments are valuable as collateral. Furthermore, the regulation that the FCA adopts today promotes portfolio diversification by establishing percentage limits on most eligible investments that FCBs, BCs, and ACBs may hold at any particular time.

The input that the FCA received from System commenters and the investment banking firm about eligible investments proved extremely useful in crafting final § 615.5140. The preamble to the individual provisions of § 615.5140 will analyze specific recommendations by the commenters and explain the FCA's positions concerning the final regulation.

A. Obligations of the United States, Its Agencies and Instrumentalities

As proposed by the FCA, § 615.5140(a)(1) would implement sections 1.5(15) and 3.1(13)(A) of the Act by authorizing Farm Credit banks to invest in obligations other than mortgage-backed securities MBSs issued or fully guaranteed as to principal and interest by the United States, or any of its agencies and instrumentalities. Such obligations are suitable for managing liquidity, reducing IRR, and investing short-term surplus funds, because they pose virtually no risk of default, and are marketable investments within the meaning of proposed § 615.5131(i). The FCA did not propose any restrictions on the percentage of Federal obligations that Farm Credit banks could hold in their investment portfolios because these obligations are, from a regulatory perspective, inherently safe and sound.

The FCA proposed to exclude MBSs that are issued or insured by an instrumentality of the United States from coverage under proposed § 615.5140(a)(1). Instead, these investments would be governed by proposed § 615.5140(a)(2).

The FCC suggested that § 615.5140(a)(1), not § 615.5140(a)(2), should cover MBSs that are issued by the Government National Mortgage Association (GNMA). The commenter reasoned that the provision in § 615.5140(a)(2) which limits the size of the MBS portfolio should not apply to GNMA mortgage-related securities because they are fully guaranteed as direct obligations of the United States. However, the FCC proposed revisions to § 615.5140(a)(2) that would impose a three-pronged interest rate sensitivity test for GNMA, FNMA, and FHLMC mortgage-related securities. The FCA agrees with the FCC's basic approach toward GNMA securities. Although final § 615.5140(a)(2) will continue to govern investments in GNMA mortgage-related securities, it will no longer restrict the amount of these securities that System banks may hold.

An FCB suggested that final § 615.5140(a)(1) should expressly authorize System banks to invest in MBSs that are issued by the Small Business Administration (SBA). The FCA's research reveals that the SBA provides financial assistance to small businesses, and then sells direct or guaranteed loans to investors through five separate programs. Some of these SBA securities are backed by the full faith and credit of the United States, while others are not. Similarly, while some SBA securities are backed by

commercial real estate mortgages, other instruments are secured by chattels.

The FCB has not identified which SBA securities it seeks to qualify as eligible investments under § 615.5140(a)(1). The FCA notes that SBA securities could, depending on the circumstances, qualify as eligible investments under either § 615.5140(a)(1), (a)(2), or (a)(11). It is conceivable that certain SBA securities are ineligible investments under this regulation. Farm Credit banks should be vigilant so that they do not purchase or hold SBA securities that are not backed by the full faith and credit of the United States.

B. Mortgage-Backed Securities

Proposed § 615.5140(a)(2) would have authorized FCBs, BCs, and ACBs to hold MBSs issued by, or fully guaranteed as to principal and interest by the GNMA, FNMA, FHLMC, and Farmer Mac so long as: (1) All adjustable rate MBSs reprice within 12 months; or (2) all fixed-rate MBSs have an absolute final maturity of 5 years from the time of purchase. Prime derivative products of MBSs, such as Collateralized Mortgage Obligations (CMOs), Real Estate Mortgage Investment Conduits (REMICs), and Stripped Mortgage-Backed Securities (SMBs), were excluded from coverage under proposed § 615.5140(a)(2). Although certain CMO and REMIC tranches are effective in managing IRR, the FCA concluded in the preamble to the proposed regulation that the universe of CMO and REMIC tranches available in the marketplace was too diverse for effective regulation. See 56 FR 65691, 65695 (December 18, 1991). The FCA also proposed to limit investments in qualified MBSs to 30 percent of the total investment portfolio of the bank.

The FCC, a BC, an FCB, Farmer Mac, and the investment banking firm criticized proposed § 615.5140(a)(2) as unduly restrictive. Most criticism of proposed § 615.5140(a)(2) focused on provisions that: (1) Imposed an absolute final maturity of 5 years on all fixed-rate MBSs; (2) precluded MBSs where the underlying adjustable rate mortgages (ARMs) could convert into fixed-rate mortgages; (3) prohibited all investments in CMOs and REMICs; and (4) limited MBSs to 30 percent of the investment portfolio.

All commenters recommended extensive revisions to proposed § 615.5140(a)(2). The FCA incorporated many of these changes into the final regulation because they are consistent with the FCA's objective of allowing System banks to invest only in MBSs that: (1) Have little or no risk; and (2)

are suitable for maintaining a liquidity reserve, managing IRR, and investing surplus short-term funds. These amendments to the final regulations should provide bank managers with more flexibility in managing risks, and enhance the quality and diversity of investment portfolios throughout the FCS.

For these reasons, the FCA now adopts as final § 615.5140(a)(2) an alternative that was offered in part by the FCC. MBSs, CMOs, and REMICs that are issued by, or guaranteed as to both principal and interest by GNMA, FNMA, or FHLMC qualify as eligible investments under final § 615.5140(a)(2). The FCA emphasizes that CMOs and REMICs that are collateralized by the MBSs of GNMA, FNMA, or FHLMC are expressly included within the ambit of this regulation even though they are packaged and sold by a private sector investment banker. All eligible securities, except those that are issued by or guaranteed as to both principal and interest on the full faith and credit of the United States, shall be rated AAA or its equivalent by a nationally recognized credit rating service.

Final § 615.5140(a)(2) imposes certain threshold requirements for ARMs and fixed-rate mortgages that back these securities. ARMs that back eligible securities shall have a repricing mechanism of 12 months or less tied to an index. The final regulation requires that the underlying fixed-rate mortgages of MBSs, CMOs, and REMICs meet the following three conditions at the time of purchase and each quarter thereafter: (1) The expected weighted average life (WAL)¹² of the instrument does not exceed 5 years; (2) 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; and (3) the estimated change in price is not more than 10 percent due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points. The FCA deleted the provision in the proposed regulation that precluded System banks from investing in securities where the underlying ARMs are convertible into fixed-rate mortgages.

¹² The FCA adopts § 615.5131(v), which defines weighted average life as the average time to receipt of principal, weighted by the size of each principal payment. Weighted average life for MBSs, CMOs or REMICs is calculated under some specific prepayment assumption.

The FCC proposed that the final regulation adopt "weighted average maturity" (WAM) as the standard for measuring the average life and average life sensitivity of mortgage-related securities. However, the FCA's research reveals that both the industry and other Federal regulators rely on WAL as the appropriate standard for gauging the average life and average life sensitivity of these instruments. WAL calculations include some prepayment assumptions, whereas WAM assumes no prepayments.

Final § 615.5140(a)(2) requires Farm Credit banks to document both their assumptions concerning the mortgage-related security and its underlying collateral, and any subsequent changes in those assumptions. The bank shall also analyze the security prior to purchase and on a quarterly basis thereafter. The final regulation compels System banks to divest any mortgage-related security that, subsequent to purchase, fails any of the aforementioned three tests concerning interest rate sensitivity.

The final regulation also allows System banks to invest in CMO floaters. Furthermore, final § 615.5140(a)(2) exempts CMO floaters that bear a rate of interest below their contractual cap from the above-cited requirements concerning the WAL. The FCA has also expanded the definition of a CMO in § 615.5131(e) so it expressly includes a CMO floating-rate debt class. According to final § 615.5131(e), the interest rate of a CMO floater adjusts at least annually pursuant to a conventional index. Inverse CMO floaters do not qualify as eligible investments under final § 615.5140(a)(2).

Two commenters dissented from the FCC's proposal. These commenters urged the FCA to adopt the FFIEC's three-pronged test for identifying high-risk mortgage-derivative products. Under the FFIEC standards, a mortgage derivative, such as a CMO, REMIC, or SMBS, shall be classified as a high-risk security if it fails any of the following three tests: (1) The expected WAL exceeds 10 years; (2) the expected WAL of the security extends by more than 4 years assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points, or shortens by more than 6 years assuming an immediate and sustained parallel shift in yield curve of minus 300 basis points; or (3) the estimated change in the price of the mortgage-derivative product is more than 17 percent, due to an immediate and sustained parallel shift in interest rates of plus or minus 300 basis points. See 57 FR 4028, 4038-39 (February 3, 1992).

One System commenter urged the FCA to elect the FFIEC's approach over the FCC's proposal. This commenter asserted that all federally regulated financial institutions should operate under the same rule concerning mortgage derivatives, and that there is no justification for applying a different regulatory treatment to System banks.

The FCA prefers the FCC's proposal to the FFIEC policy for several reasons. First, the conservative standards advocated by the FCC apply to both securities backed by fixed-rate mortgages, and to CMOs and REMICs, whereas the FFIEC policy statement covers high-risk mortgage-derivative products, including SMBSs. Second, the FCC's approach is specifically tailored to the needs of Farm Credit banks because § 615.5140(a)(2) establishes standards for mortgage-related securities that are compatible with the investment objectives of § 615.5132. Third, the FCA notes that § 615.5140(a)(2) and the FFIEC policy statement are geared to entirely different objectives. Depository institutions, in their capacity as primarily lenders, routinely originate the residential mortgages that collateralize these securities, whereas Farm Credit institutions have only limited statutory authority to make (rural) residential loans that back these mortgage-related instruments. Thus, depository institutions are exposed to the risks of loss on the types of loans that underlie these securities, while the FCS generally is not. In this context, the FCA's regulation establishes the parameters of an eligible investment. In contrast, the FFIEC policy does not prohibit depository institutions from investing in high-risk mortgage derivatives. Instead, it only establishes a three-pronged test for determining if individual mortgage-derivative products should be classified as high-risk securities.

Most commenters judged the proposed 30-percent limit on mortgage-related securities as inadequate. The FCC and all System commenters advanced the following arguments in support of their position for a higher limit: (1) The regulation already imposes the highest credit quality standards on eligible mortgage-related securities; (2) these investments are effective tools for managing IRR and enhancing liquidity; and (3) advanced computer technology provides System banks with continual access to analytical information about the performance of these securities.

As noted in the preamble to § 615.5140(a)(1), the FCC opposed any ceiling on investments by System banks in GNMA mortgage-related securities.

This commenter also encouraged the FCA to raise the limit on FNMA and FHLMC mortgage-related securities from 30 to 60 percent. Another commenter advised the FCA to abolish all regulatory restrictions on the percentage of GNMA, FNMA, or FHLMC mortgage-related securities that System banks may hold in their investment portfolios. This commenter warned that other regulators and the marketplace may misconstrue the FCA's position, and conclude that the FCA is questioning the creditworthiness of GNMA, FNMA, and FHLMC. The commenter also expressed concern that other regulators may retaliate by imposing limits on the purchase of System obligations by other financial institutions or GSEs.

Final § 615.5140(a)(2)(vi) eliminates all restrictions on the amount of GNMA mortgage-related securities that Farm Credit banks may hold in their investment portfolios. The FCA notes that private sector investment firms often convert GNMA MBSs into CMOs and REMICs. The investor purchases a private label security which is fully collateralized with GNMA securities, which in turn are backed by the full faith and credit of the United States. Since GNMA mortgage-related securities pose no credit risk (insofar as principal and interest income is concerned) to the investor, the FCA has decided to authorize System banks to purchase and hold these investments without regulatory restriction as to amount. In this context, management should determine how GNMA mortgage-related securities best meet the investment objectives of the bank. Similarly, this provision applies to mortgage-related securities of the SBA or other Federal government agencies which: (1) Are backed by the full faith and credit of the United States; (2) secured by real estate; and (3) comply with the other requirements of § 615.5140(a)(2). The FCA reiterates that Farm Credit banks should be vigilant so that they do not purchase or hold mortgage-related securities that are issued or guaranteed by the SBA or another government agency unless they are backed by the full faith and credit of the United States.

The FCA has decided to raise the ceiling on FNMA and FHLMC mortgage-related securities from 30 to 50 percent of the total investment portfolio of banks. The commenters have convinced the FCA that the high credit quality of these securities warrants a more liberal approach toward System participation in this market. However, the FCA rejects a 60-percent limit because it is concerned that the investment portfolios of System banks could become too

heavily concentrated in mortgage-related securities.

Several months after the second comment period expired, Farmer Mac submitted a comment letter to the FCA concerning proposed § 615.5140(a)(2). More specifically, Farmer Mac objected to FCA's decision to include Farmer Mac securities within the ambit of this regulation. The commenter asserted that the secondary agricultural mortgage market is a logical extension of the System's agricultural lending operations. In the commenter's opinion, Farmer Mac securities enhance the credit quality and liquidity of System loan portfolios, but they do not satisfy the asset/liability management objectives of § 615.5132. For this reason, Farmer Mac argued that its securities should not be accorded the same regulatory treatment as investments which are unrelated to agricultural lending. The commenter also complained that other Federal bank regulatory agencies did not similarly impede participation by their institutions in the Farmer Mac securities market.

The FCC implied that Farmer Mac securities should be excluded from § 615.5140(a)(2) because it proposed regulatory language for § 615.5140(a)(2) that omitted all of FCA's references to Farmer Mac.

After careful reflection, the FCA has decided to exclude Farmer Mac securities from coverage under final § 615.5140(a)(2). The FCA agrees with the commenter that Farmer Mac securities fulfill a different set of investment criteria for System banks than GNMA, FNMA, and FHLMC mortgage-related securities. Accordingly, the FCA adopts new regulations in subpart F of part 615 that shall govern investments by FCS institutions in guaranteed Farmer Mac securities. This new authority shall be addressed at length in the preamble to subpart F.

C. Negotiable Certificates of Deposit

The FCA proposed substantial revision to the existing regulation governing investments by Farm Credit banks in negotiable certificates of deposit (CDs). The FCA expressed concern that: (1) The investment portfolios of Farm Credit banks are too heavily concentrated in commercial banks; and (2) CDs expose Farm Credit banks to undue financial risks because the commercial banking and thrift industries have recently experienced significant difficulties. See 56 FR 65691, 65697 (December 18, 1991). Accordingly, the FCA proposed amendments to this regulation that

would remedy these problems by limiting System bank investment in negotiable CDs, and imposing credit quality standards on these instruments.

The proposed regulation would retain the existing requirement that Farm Credit banks only hold negotiable CDs. Proposed § 615.5140(a)(5) would require all FCBs, BCs, and ACBs to limit their holdings of negotiable CDs to 30 percent of their investment portfolio, while proposed § 615.5140(b) would prohibit Farm Credit banks from concentrating their CD investments in a limited number of depository institutions. The FCA also proposed that all negotiable CDs held by Farm Credit banks mature within 1 year or less. To the extent that a domestic, Yankee, or Eurodollar CD is not insured by an agency of a Federal or national government, the proposed regulation would require that: (1) The depository institution maintain at least a B, or equivalent credit rating by a nationally recognized credit rating service; and (2) the foreign country where Eurodollar CDs are held to maintain an AAA, or equivalent rating for political and economic stability from a nationally recognized credit rating service.

The FCC and a FCB offered amendments to both proposed § 615.5131(l), which defines negotiable CDs, and proposed § 615.5140(a)(5). As requested by these commenters, final (and redesignated) § 615.5131(m) defines negotiable CDs as instruments issued as "evidenced by definitive or book-entry form," rather than instruments "evidenced by a certificate." This revision is designed to conform the final regulation to current industry practices and standards concerning the issuance of negotiable CDs.

These two commenters also urged the FCA to expand this category of investments to include Eurodollar deposits at foreign banks and overseas branches of American banks. Although the commenters conceded that Eurodollar deposits are non-negotiable and less liquid than other investments, they asserted that these instruments are suitable for managing short-term cashflows at System banks. The FCC and the FCB had different views about the maximum maturity that the final regulation should impose on Eurodollar deposits.

The final regulation does not authorize System banks to hold Eurodollar deposits because they are not negotiable instruments. A non-negotiable CD contains restrictions on its transferability, which in turn, adversely impacts its marketability and liquidity. In this context, non-negotiable

CDs do not accomplish the FCA's goal of reducing the exposure of System banks to the risks of the commercial banking industry.

The commenters also requested that the FCA reduce the credit ratings in § 615.5140(a)(5) to: (1) B/C for depository institutions; and (2) AA for political and economic stability of the host country where the funds are deposited. The FCA agrees to lower the credit rating for depository institutions to B/C which represents a larger universe of commercial banks that are of acceptable short-term investment grade. However, the FCA shall only permit System banks to hold Eurodollar CDs in foreign countries that achieve the highest rating for political and economic stability, and therefore, System requests to lower this standard are denied. Similarly, the FCA declines advice to expand the maximum maturity on negotiable CDs to 24 months because a time deposit with a shorter maturity is more liquid. Accordingly, final § 615.5140(a)(5) will require negotiable CDs to mature within 1 year or less.

The commenters requested that FCA further revise § 615.5140(a)(5) by doubling the limit on negotiable CDs from 30 to 60 percent. As recommended by these commenters, Farm Credit banks would be authorized to hold 30 percent of their investments in domestic CDs, 30 percent in Eurodollar and Yankee CDs, and 30 percent in Federal funds under § 615.5140(a)(6). Under the System's proposal, accounts at depository institutions could comprise 90 percent of any System bank's investment portfolio.

The System's proposal cannot be reconciled with the FCA's objective of prompting Farm Credit banks to diversify their investment portfolios so they no longer remain heavily concentrated in depository institutions. Interestingly, the ABA expressed no objection to the FCA's proposal to impose restrictions on System bank investments in CDs and Federal funds. Yet, System commenters ignored the FCA's safety and soundness concerns, and instead advocated greater concentration of System investments in the commercial banking sector.

Final § 615.5140(a)(5) prohibits FCBs, BCs, and ACBs from holding more than 25 percent of their investments in negotiable CDs. Since the FCA raised the investment ceiling in § 615.5132 from 20 to 30 percent, it lowered the limit on negotiable CDs from 30 to 25 percent. In spite of this modification, the overall level of permissible System bank investment in negotiable CDs is still slightly higher under the final

regulation than it was under the proposed regulation.

D. Federal Funds

Proposed § 615.5131(f) would define Federal funds as loans, for 1 business day or under a continuing contract, to a federally insured depository institution. Based on this definition, proposed § 615.5140(a)(6) would authorize Farm Credit banks to hold Federal funds that mature within 1 business day, or are subject to a callable contract. The proposed regulation would also limit Federal funds to 30 percent of the bank's investment portfolio in order to encourage risk diversification. From the FCA's perspective, the short maturity on Federal funds are suitable for managing liquidity and investing surplus short-term funds.

The FCC, two FCBs, and a BC proposed revisions to §§ 615.5131(f) and 615.5140(a)(6). All commenters recommended that the FCA amend § 615.5131(f) so System banks are permitted to engage in Federal funds transactions with other GSEs. The FCA adopts this amendment so System banks can more fully participate in the Federal funds market.

System commenters also urged the FCA to expand this definition to include Term Federal funds that are not subject to a callable contract, but mature within 2 to 100 days. One commenter requested that the final regulation authorize System banks to invest in callable Federal funds that mature within 2 years. In response, the FCA will amend the regulation so System banks can hold Term Federal funds that, subject to a callable contract, mature within 2 to 100 days.

From a regulatory perspective, a callable feature provides liquidity for such instruments. Investors in non-callable Term Federal fund contracts sacrifice liquidity in exchange for a higher return. The investors are exposed to loss if the issuer defaults at any time before the instrument matures. In contrast, a callable Term Federal funds contract enables the holder to withdraw its funds at any time. By restricting System bank investments to callable Term Federal funds, the FCA continues to bar the use of non-negotiable investments in subpart E.

The FCA has decided to impose a maximum maturity of 100 days on Term Federal funds for two separate reasons. First, research by the FCA reveals that the market for Term Federal funds with a maturity that exceeds 100 days is sparse. Second, a maximum maturity of 100 days is a standard that would require System banks to periodically

review the creditworthiness of the issuer.

The final regulation also requires depository institutions that engage in Term Federal fund transactions with any Farm Credit bank to maintain a B/C credit rating. This safety and soundness standard is a logical extension of the System proposals to expand coverage of the regulation to Term Federal funds.

Two commenters petitioned the FCA to raise the limit on Federal funds from 30 to 60 percent. Although these commenters acknowledged that their proposal would further concentrate System investments in the commercial banking industry, they asserted that Farm Credit banks could effectively contain the attendant risks through internal credit quality control standards. These commenters urged the FCA to increase this limit in order to accommodate those System banks that depend upon large holdings of Federal funds to perpetuate short-term funding strategies. These commenters complained that the FCA's proposal would arbitrarily force such banks to abandon their current funding strategies, and divest a significant portion of their Federal funds. These two commenters claimed, without explanation, that diversification away from commercial bank investments will actually increase, rather than decrease, the exposure of Farm Credit banks to loss.

The FCA responds that no financial institution can effectively reduce its loss exposure without relying on both portfolio diversification and stringent credit quality standards. From a safety and soundness perspective, high credit ratings, short maturities, and geographic or institutional diversification cannot sufficiently alleviate the risks inherent in an investment portfolio that is heavily concentrated in a single industry.

Final § 615.5140(a)(6) authorizes Farm Credit banks to hold up to 25 percent of their investments in Federal funds and Term Federal funds. The FCA has lowered the limit on Federal funds and Term Federal funds from 30 to 25 percent in order to partially offset the increase in the overall investment ceiling in § 615.5132 from 20 to 30 percent.

E. Prime Commercial Paper

The FCA defined prime commercial paper in proposed § 615.5131(n) as an unsecured promissory note of a corporation that has a fixed maturity of no more than 270 days, and is rated A-1 or P-1 by a nationally recognized credit rating service. Proposed

§ 615.5140(a)(7) would authorize Farm Credit banks to hold prime commercial paper in an amount that does not exceed 30 percent of their investment portfolios, while proposed § 615.5140(b) would restrict the amount that any System bank could invest in commercial paper issued by a single issuer. In situations where the commercial paper is issued by a foreign corporation, or the overseas subsidiary of a United States corporation, the country where the issuer is incorporated would be required by proposed § 615.5140(a)(7) to receive the highest possible rating (AAA) for political and economic stability from a nationally recognized credit rating service.

The FCA received comments about proposed §§ 615.5131(n) and 615.5140(a)(7) from the FCC. As recommended by the commenter, the FCA revises the definition of prime commercial paper in redesignated § 615.5131(o) to include both secured and unsecured promissory notes of corporation. The exclusion of secured promissory notes from the proposed regulation was an inadvertent error.

The FCA rejects the FCC's advice to downgrade the credit rating for political and economic stability of foreign host countries from an AAA to an AA. The commenter's assertion that an AAA rating is "unduly restrictive" appears to be unfounded. The FCA notes that Canada, Japan, Austria, Germany, France, Luxembourg, Netherlands, Switzerland, and the United Kingdom currently qualify for an AAA rating.

F. Corporate Debt Obligations

The FCA proposed § 615.5140(a)(8), which would authorize Farm Credit banks to hold corporate debt obligations that: (1) Mature within 3 years or less; (2) are rated in the two highest investment grades (AA or AAA) by a nationally recognized credit rating service; and (3) are not convertible into equity securities. Additionally, the proposed regulation would limit corporate debt obligations to 15 percent of the bank's total investment portfolio.

The FCA proposed this new authority in order to encourage Farm Credit banks to diversify their investment portfolios. From a regulatory perspective, a short-term maturity deadline and a superior credit rating ensures that Farm Credit banks only purchase highly liquid corporate debt obligations with limited IRR. The proposed regulation would also prohibit Farm Credit banks from holding corporate debt obligations that are convertible into equity securities, because FCA believes that it is inappropriate for the banks to maintain

an ownership interest in commercial enterprises.

The FCC, one FCB, and the investment banking firm commented about proposed § 615.5140(a)(8). The FCC recommended that the FCA increase the maturity for corporate bonds from 3 to 5 years. According to this commenter, the proposed regulation would actually inhibit System banks from exercising this new investment power because corporate obligations with a 3-year maturity are rarely available in the market. This commenter also opined that a maximum maturity of 5 years is a reasonable limitation that still affords adequate safety of principal risk. The FCA is persuaded by these arguments, and therefore, it amends § 615.5140(a)(8) so that corporate obligations that mature within 5 years or less are eligible investments under the final regulation. For the reasons explained in the preambles to §§ 615.5140(a)(5) and 615.5140(a)(7), the FCA, rejects the FCC's request to downgrade the credit rating for political and economic stability of host foreign countries from AAA to AA.

In response to another FCC comment, the FCA clarifies that corporate debt obligations under § 615.5140(a)(8) include bonds, debentures, medium-term notes, and similar forms of indebtedness.

The FCB requested that the FCA modify § 615.5140(a)(8)(iv), which prohibits FCBs, BCs, and ACBs from holding corporate obligations that are convertible into equity securities. While the commenter conceded that it is inappropriate for Farm Credit banks to acquire an ownership interest in commercial enterprises, it argued that the FCA's approach was too rigid. Accordingly, the FCB suggested that the final regulation accord convertible corporate debt the status of eligible investments, but prohibit System banks from exercising the conversion option. The commenter claimed that the convertible feature on corporate debt actually adds value to the investment in certain situations.

The FCA denies the commenter's request. From the FCA's perspective, convertible corporate debt investments are not effective for IRR management because the price performance of these obligations fluctuates with the price of the underlying common stock. Additionally, investors in convertible bonds traditionally are influenced by the equity factor, and as indicated by the commenter, equity holdings are inappropriate investments for Farm Credit banks.

The FCC and the investment banking firm petitioned the FCA to expand the

list of eligible investments to include asset-backed securities (ABSs). The FCC specifically recommended that the FCA classify ABSs as corporate obligations and include them within the ambit of § 615.5140(a)(8), while the investment banking firm noted the similarity between ABSs and corporate debt securities. Both commenters suggested that the regulation impose a credit rating of AAA or its equivalent on ABSs, and the FCC proposed that eligible ABSs have an absolute final maturity of 5 years. These commenters emphasized that: (1) A broad secondary market for these securities has developed in recent years; and (2) ABSs possess the characteristics that make them effective instruments for safely and soundly managing liquidity and interest rate risks. The FCC pointed out that the cashflow structures of most ABSs are simpler and more dependable than MBSs.

The FCA accedes to the commenters' request, subject to certain modifications. ABSs are similar to MBSs, except that they are backed by collateral other than real estate mortgages. A diverse array of ABSs is available in the marketplace. According to the FCA's research, investors can purchase ABSs that are collateralized by credit card receivables, accounts receivables, automobile loans, home equity loans, boat loans, recreational vehicle loans, manufactured home loans, equipment leases, delinquent loans, and junk bonds.¹³

As noted earlier, the FCA's investment policy is based on the premise that only those investments that can be promptly converted into cash on an established secondary market are suitable for liquidity, IRR management, and the investment of surplus short-term funds. In order to qualify as an eligible investment under § 615.5140(a), an asset must: (1) Have a short maturity or a repricing mechanism; (2) maintain a high investment credit rating; (3) trade on an active and universally recognized secondary market; and (4) be valuable as collateral.

After careful analysis, the FCA concludes that only public issues of ABSs that are collateralized by either credit card receivables (CARDs) or automobile loans (CARs) meet these criteria. CARDs and CARs represent approximately 80 percent of the ABS market.¹⁴ ABSs that are collateralized by other types of assets do not qualify as eligible investments under this regulation because the FCA's research

reveals that: (1) Supply is limited; (2) their market is fragmented; (3) they are not liquid; and (4) it is difficult to appraise their market value.

Accordingly, final § 615.5140(a)(8)(ii) authorizes all FCBs, BCs, and ACBs to invest in ABSs, as defined by new § 615.5131(c) that: (1) Are collateralized by CARDs and CARs; (2) mature within 5 years or less; and (3) maintain a credit rating of AAA or its equivalent by a nationally recognized credit service. Upon the FCC's recommendation, final § 615.5140(a)(8) will combine ABSs and corporate bonds into a single investment category. As a result, investments under § 615.5140(a)(8) cannot exceed 15 percent of the total investments of any Farm Credit bank.

G. Repurchase Agreements

As adopted today by the FCA, final § 615.5140(a)(9) enables FCBs, BCs, and ACBs to invest in repurchase agreements, as defined by final § 615.5131(q), that are collateralized by eligible investments authorized by § 615.5140, and mature within 100 days (generally known in the industry as "reverse repurchase agreements").

The FCA originally proposed that repurchase agreements mature within 1 business day, or are by a continuing contract. The FCA expanded the term "to maturity of 100 days or less" in response to a comment from the FCC. The commenter advised the agency that System banks usually engage in repurchase transactions near the end of a quarter, when short-term investment assets may not be readily obtainable. The FCC also noted that a shorter term to maturity would severely restrict the ability of Farm Credit banks to effectively use repurchase agreements for hedging. The FCA adopts the amendment proposed by the FCC so System banks have greater flexibility to use repurchase agreements to meet their investment objectives.

H. Other Investments

The FCA recognized in the preamble to the proposed regulation that new financial instruments are constantly being developed in financial markets, and many of these new instruments may be suitable for managing liquidity, managing interest rate risk, and investing surplus short-term funds. See 56 FR 65691, 65698 (December 18, 1991). Accordingly, the FCA proposed § 615.5140(a)(11) which would authorize Farm Credit banks to purchase, subject to FCA approval, other financial instruments that: (1) Have short maturities; (2) are marketable investments pursuant to proposed § 615.5131(j); and (3) maintain a high

¹³ Lehman Brothers, Mortgage Strategies Group, (January 1993), p. 70.

¹⁴ *Id.*

rating from a nationally recognized credit rating service. The FCA received no comments about this proposal. Accordingly, the FCA has decided to adopt § 615.5140(a)(11) as a final regulation, without any amendments. Under the regulatory framework of § 615.5140(a)(11), the FCA shall determine on a case-by-case basis whether a new financial instrument qualifies as an eligible investment.

One FCB, however, submitted a long list of instruments that it wanted the FCA to classify as eligible investments under final § 615.5140. This commenter urged the FCA to approve these investments at this time, because any postponement in resolving this issue would inevitably create confusion among System banks. Although this recommendation was not specifically made in reference to § 615.5140(a)(11), the FCA will address this comment in the context of this provision.

While the FCA wishes to accommodate the FCB's request, it is unable to do so. Unfortunately, the commenter failed to describe these instruments with enough specificity so that the FCA could properly evaluate these investments under the criteria of § 615.5140(a)(11). The commenter used generic terms that encompass several differing subcategories of investments. Sometimes the commenter referred to accounting or financing techniques rather than actual investment instruments.

The FCA is prepared to issue interpretive booklets that respond to inquiries concerning whether particular securities qualify as eligible investment under § 615.5140(a)(11). However, petitioners should, at a minimum, submit information pertaining to: (1) The cashflow structures of such securities; (2) terms to maturity; (3) credit ratings; (4) the scope of the secondary markets where these instruments are traded; and (5) the value of such instruments as collateral. Furthermore, a party that submits an inquiry should evaluate whether the proposed investment will enable System banks to achieve their objectives of maintaining an adequate liquidity reserve, managing IRR, and prudently investing short-term funds. Without such information, the FCA will probably be unable to determine whether the proposed investment complies with the criteria of § 615.5140(a)(11).

VIII. Risk Management and Diversification

In order to compel System banks to diversify the risks in their investment portfolios for safety and soundness purposes, the FCA proposed percentage

limits on the amount of capital that each bank could invest with a single obligor, issuer or financial institution. As originally proposed by the FCA, § 615.5140(b) would limit investments with individual domestic issuers, obligors or financial institutions to 20 percent of the bank's total capital, while investments with each foreign issuer, obligor or financial institution could not exceed 10 percent of a bank's total capital. The FCA justified the more stringent limit on overseas investments in the preamble to the proposed regulation by noting the political and/or economic risks in many foreign countries. See 56 FR 65691, 65698 (December 18, 1991).

The FCC objected to the disparate treatment of domestic and foreign investments. This commenter asserted that the obligor's creditworthiness, not its nationality, is the relevant issue from a safety and soundness perspective. In this context, the FCC pointed out that foreign obligors, (particularly in the commercial banking sector) are often more creditworthy than their American competitors. Accordingly, the FCC recommended that final § 615.5140(b) limit investments with individual issuers, obligors or financial institutions, whether domestic or foreign, to 20 percent of the total capital of each Farm Credit bank.

The FCA is persuaded by the FCC's arguments, and therefore, it amends § 615.5140(b) so that investments with each institution, issuer, or obligor, whether domestic or foreign, does not exceed 20 percent of the total capital of any System bank.

IX. Divestment of Impermissible Investments

The FCA realizes that some Farm Credit banks may currently hold investments that will no longer be permissible after final § 615.5140 becomes effective. Certain investments will become ineligible because they do not comply with the investment criteria (such as credit ratings or maturity deadlines) of § 615.5140(a). Conversely, other investments qualify as eligible investments under final § 615.5140, but the bank currently exceeds the percentage limitations that the regulation imposes on a certain category of investments. While the FCA intends that all Farm Credit banks dispose of ineligible investments as quickly as possible, the agency seeks to avoid situations where the banks are exposed to heavy losses.

The FCA anticipated this problem, and it originally proposed § 615.5142, which would require System banks either to dispose of all prohibited

investments within 6 calendar months from the effective date of the final regulation, or in the alternative, to obtain approval from the Director of the Office of Examination for a comprehensive plan to bring the bank's portfolio into compliance with § 615.5140 over a longer period of time. Under the FCA's proposal, all applications, and all subsequent approvals or denials would be in writing. The proposed regulation would require the Director of the Office of Examination to consider all relevant factors, such as earnings and capital, when deciding whether to approve a compliance plan. Under the regulatory framework of proposed § 615.5142, an acceptable compliance program would enable a bank to divest of impermissible investments as soon as possible, without substantial loss.

The FCC endorsed the FCA's position about the divestiture of investments that will become ineligible once final § 615.5140 takes effect. Furthermore, this commenter advised the FCA that the final regulation should also apply to situations where an investment complied with final § 615.5140(a) at the time of purchase, but subsequently became ineligible. Thus, the FCC's proposal would similarly require a System bank to complete divestiture within 6 months after the investment became ineligible, unless the Director of the Office of Examination approved a comprehensive written compliance plan that authorized divestiture over a longer period of time. As recommended by the commenter, the regulation would also require the portfolio managers to report, on a quarterly basis, to the board of directors about: (1) The conditions that rendered the investment ineligible; (2) the status of the investment; and (3) the divestiture plan.

The FCA appreciates the FCC's support concerning divestiture of ineligible investments. The FCA agrees with the commenter that § 615.5142 should also apply to those assets that qualified as eligible investments under final § 615.5140(a) at the time of purchase, but later became ineligible. Several factors could cause an asset to lose its status as an eligible investment. Most investments listed in § 615.5140(a) could become ineligible after purchase if a nationally recognized credit rating service downgrades their credit rating. Mortgage-related securities would be rendered ineligible under final § 615.5140(a)(2) if, in a quarter subsequent to purchase, an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points either: (1) Extends the WAL for more than 2 years; (2) shortens the WAL for

more than 3 years; or (3) changes the price of the instrument by more than 10 percent. The FCA adopts the FCC's proposal with minor modifications and stylistic edits that enhance its clarity.

One FCB dissented from the FCC's position. This commenter advised the FCA to "grandfather" those securities that were eligible investments under the pre-existing regulation. The FCA rejects this suggestion because the FCA's approach affords Farm Credit banks protection against loss while they diversify and enhance the credit quality of their investment portfolios under the new regulation.

X. Impact of Statement of Financial Accounting Standard No. 115

System institutions are required to follow the Statement of Financial Accounting Standard No. 115 (SFAS No. 115), Accounting for Certain Investments in Debt and Equity Securities, for fiscal years beginning after December 15, 1993. The FCA now addresses the potential impact of SFAS No. 115 on investments at System institutions. SFAS No. 115 establishes generally accepted accounting principles (GAAP) for investments that System institutions are authorized to invest in accordance with §§ 615.5140 and 615.5174. All institutions are to follow GAAP in preparing their financial statements. In this regard, the FCA is of the opinion that SFAS No. 115 would generally consider most of investments held by System institutions authorized by §§ 615.5140 and 615.5174 to be considered "available-for-sale securities" as defined in SFAS No. 115. As a result of this classification, such securities considered would be measured at fair value in the statement of financial position. It is possible that some investments held by System institutions may be classified as "held-to-maturity securities" as defined in SFAS No. 115, and carried at amortized cost in the statement of financial position. Such a classification will require documentation that an institution has the positive interest and ability to hold such securities to maturity as further defined in SFAS No. 115. In summary, where an investment is classified as a "held-to-maturity security," § 615.5141 provides for divestiture in a manner that protects the bank from loss to capital and earnings. However, when an investment in an "available-for-sale" classification must be divested pursuant to § 615.5141, the mark-to-market requirements of SFAS No. 115 should cause the impact on capital to be insignificant because the security should have already been reflective of the market price.

XI. Investments in Farmer Mac Securities

As discussed earlier, System commenters opposed the FCA's original proposal to include guaranteed Farmer Mac MBSs within the ambit of § 615.5140(a)(2), which authorizes Farm Credit banks to invest in the mortgage-related securities of GNMA, FNMA, and FHLMC and other Federal Government agencies. Farmer Mac asserted that its mortgage-related securities merit a more liberal treatment under these regulations than comparable GNMA, FNMA, and FHLMC instruments, because Farmer Mac advances the mission of Farm Credit banks to provide credit to agricultural producers and rural homeowners. Farmer Mac argued that proposed § 615.5140(a)(2) would severely impede the ability of Farm Credit banks to participate in a secondary market that Congress established in order to minimize the risks inherent in agricultural lending. This commenter also complained that the FCA's proposal would place greater restrictions on FCS investments in Farmer Mac guaranteed securities than the other Federal bank regulatory agencies currently impose on their institutions. Accordingly, this commenter suggested that the FCA remedy this problem in the final regulations by exempting guaranteed Farmer Mac securities from restrictions that § 615.5140(a)(2) imposes on securities that are collateralized by mortgages that FCS institutions cannot originate. The FCC and individual Farm Credit banks implied that final § 615.5140(a)(2) should not cover Farmer Mac securities because their comments about this provision omitted all references to Farmer Mac, and instead, focused exclusively on mortgage-related securities that are issued by GNMA, FNMA, FHLMC, and the SBA.

In response, the FCA concurs that guaranteed Farmer Mac securities serve a different purpose for Farm Credit banks than the mortgage-related securities of GNMA, FNMA, FHLMC, and other Federal government agencies. In contrast to GNMA, FNMA, and FHLMC, Farmer Mac furthers the FCS's statutory mission of lending to agricultural producers and rural homeowners. As a secondary market for agricultural and rural housing loans, Farmer Mac enables FCS institutions and other agricultural lenders to reduce various credit risks that are inherent in their agricultural loan portfolios. As such, FCS institutions are unlikely to hold guaranteed Farmer Mac mortgage-

related securities in order to achieve the objectives listed in § 615.5132.

For these reasons, the FCA will accede to the commenters' request to accord guaranteed Farmer Mac mortgage-related securities a different regulatory treatment in the final regulations than comparable mortgage-related securities of GNMA, FNMA, and FHLMC and other Federal agencies. While both the primary and secondary market sectors of the FCS rejected the FCA's approach in the proposed regulations for Farmer Mac securities, no commenter offered any affirmative advice about how Farmer Mac securities should be treated in the final regulations. As result, the FCA devised final § 615.5174 without the benefit of guidance from the FCS or other commenters.

The FCA decided to address FCS bank investment in guaranteed Farmer Mac securities in subpart F, rather than subpart E, of part 615. This approach will exempt guaranteed Farmer Mac securities from many of the requirements of regulations in subpart E of part 615, which establish the criteria by which Farm Credit banks purchase, hold, and divest of financial investments that are unrelated to their statutory mission of financing agriculture and rural housing.

Final § 615.5174, which the FCA adopts today, is not a comprehensive regulation that governs all aspects of System participation in the Farmer Mac secondary market. Although provisions in titles I, II, and VIII of the Act authorize FCBs and associations to originate, pool, and securitize agricultural and rural housing loans, final § 615.5174 does not implement these authorities. Instead, final § 615.5174 authorizes FCBs, BCs, and ACBs to purchase and hold guaranteed Farmer Mac mortgage-related securities as investments pursuant to sections 1.5(15), 3.1(13)(A) and 7.2(a) of the Act. In this context, final § 615.5174 authorizes BCs to purchase and hold mortgage-related securities that are guaranteed as to both principal and interest by Farmer Mac, even though such banks lack statutory authority to originate, pool, or securitize the types of agricultural and rural housing loans that collateralize Farmer Mac securities. Similarly, final § 615.5174 clarifies that ACBs are authorized to invest in guaranteed Farmer Mac securities under section 7.2 of the Act. Pursuant to sections 2.2(11), 2.2(18), 7.6(c) and 7.8(b) of the Act, § 615.5141 permits FCS associations to purchase and hold guaranteed Farmer Mac securities to the extent authorized under final

§ 615.5174, subject to the approval of their supervising banks.

A mortgage-related security qualifies as an eligible investment for Farm Credit banks under § 615.5174 to the extent that Farmer Mac guarantees the investor timely payment of both principal and interest in the event of default by either the borrower or the pooler. Conversely, this regulation does not apply to the subordinated participation interest in the pool of qualified mortgages that the originator or pooler retains under section 8.6(b) and 8.7(b) of the Act. Farmer Mac securities are eligible investments for Farm Credit banks under § 615.5174 only if they are collateralized by qualified loans, which are defined by section 8.0 of the Act as: (1) Agricultural real estate mortgages and rural housing loans that comply with specific requirements; and (2) loans guaranteed by the Farmers' Home Administration (FmHA) under the Consolidated Farm and Rural Development Act, 7 U.S.C. 1921 *et seq.* Furthermore, fixed-rate mortgages or ARMs, which reprice within 12 months pursuant to an index, shall collateralize MBSs, CMOs, and REMICs that are authorized by this regulation. Stripped MBSs, as defined by § 615.5131(r), and residuals, as defined by § 615.5131(s) are ineligible investments under § 615.5174(c) because they are extremely volatile to interest rate and price fluctuations.

This regulation allows each FCB, BC, and ACB to purchase and hold guaranteed Farmer Mac securities in an amount that does not exceed 20 percent of its total outstanding loans. The FCA has decided to limit the overall investment by Farm Credit banks in these securities for several reasons. First, recent studies of the secondary market for agricultural mortgages indicate that only about 20 percent of FCS loans will comply with Farmer Mac underwriting standards. Second, the FCA interprets Farmer Mac's comment letter as indicating that a 20-percent ceiling is appropriate for FCS investment in these instruments. In this context, the FCA notes that it has followed the recommendation of various System commenters to significantly increase, in the final regulation, the amount that Farm Credit banks may invest in the mortgage-related securities of GNMA, FNMA, FHLMC, and Farmer Mac. Third, this limit reinforces the cooperative principles of the FCS. Although Farmer Mac securities are agriculturally based financial assets, they no longer constitute loans to the shareholders of System institutions. An FCS institution, at its option, may retire

the borrower's stock once the loan is sold into a Farmer Mac pool.

Final § 615.5174(d) requires the board of directors of each Farm Credit bank to adopt and enforce written policies and procedures that will guide portfolio managers whenever the bank invests in guaranteed Farmer Mac securities. Furthermore, the regulation mandates that the board of each FCB, BC, and ACB shall review these policies and procedures, and evaluate the performance of the Farmer Mac securities in its portfolio, on an annual basis. In this context, final § 615.5174(d) tailors the requirements of § 615.5133 to FCS investments in guaranteed Farmer Mac securities. This regulatory approach toward guaranteed Farmer Mac securities is consistent with the investment policy that the FCA has espoused throughout this rulemaking.

An acceptable board policy shall address, at a minimum, eight broad areas related to the bank's investment in guaranteed Farmer Mac securities. Section 615.5174(d)(1) requires the board's policy to identify the objectives that the bank plans to achieve by purchasing and holding guaranteed Farmer Mac securities. Credit enhancement, and geographic and product diversification of the bank's agricultural credit portfolio are examples of the purposes and objectives that should be addressed in the policy statement. Under § 615.5174(d)(2), the policy should establish parameters concerning the size, characteristics, and quality of the bank's investment in guaranteed Farmer Mac securities. More specifically, § 615.5174(d)(2) requires the board's policy, at a minimum, to establish: (1) The mix of guaranteed Farmer Mac securities collateralized by agricultural real estate mortgages, rural home loans, and FmHA loans; (2) product and geographic diversification in the loans that underlie the securities; (3) minimum pool sizes, the minimum number of loans in each pool, and the maximum allowable premium the bank shall pay for CMOs, REMICs, and ARMs; and (4) the mix of guaranteed Farmer Mac securities that are collateralized by either fixed-rate loans, or ARMs that are tied to an index and reprice within 12 months. While Farmer Mac underwriting standards establish basic benchmark characteristics for the mortgage pools that underlie these securities, final § 615.5174(c)(2) requires boards of directors to set criteria that guides portfolio managers in selecting Farmer Mac securities that best enhance the quality of the banks' assets.

Under § 615.5174(d)(3), the board's policy shall delegate authority to manage the bank's portfolio of

guaranteed Farmer Mac securities to specific personnel or committees. The board is required by § 615.5174(d)(4) to select permissible brokers, dealers, and other intermediaries for conducting purchase and sale transactions involving guaranteed Farmer Mac securities. Section 615.5174(d)(5) incorporates the provision in § 615.5133(h) which requires the board of each Farm Credit bank to establish internal controls that prevent loss, fraud, embezzlement, and unauthorized investments.

Final § 615.5174(d)(6) requires the board of directors of each Farm Credit bank to adopt a policy pursuant to § 615.5174(e), for managing the IRR that is inherent in guaranteed Farmer Mac securities. In a related context, the board's policy under § 615.5174(d)(7) shall establish procedures to prevent losses to the capital and earnings of the bank resulting from transactions in Farmer Mac securities. Finally, § 615.5174(d)(8) requires the board's policy to establish procedures selling these securities prior to maturity, without causing financial loss to the bank.

Section 615.5174(e) requires each System bank to develop and implement a comprehensive policy for combatting IRR in guaranteed Farmer Mac securities that are collateralized by fixed-rate mortgages. Farmer Mac securities may contain IRR. If market interest rates increase, the market value of the mortgage-related security declines, and as a result, the investor may be forced to sell the instrument at a discount. However, a significant decline in market interest rates may not necessarily increase the market value of the security because many borrowers will probably exercise their contractual option to prepay their underlying mortgages. Prepayments deprive investors in mortgage-related securities of interest income. While Farmer Mac guarantees timely principal and interest payments to investors in the event of default by either the borrowers or the holders of the subordinated participation interests, it does not protect investors against prepayment or interest rate risks.

The FCA received no comments about how the final regulation should address IRR in Farmer Mac securities. The proposed regulation sought to contain the IRR exposure of Farm Credit banks to mortgage-backed securities by allowing them to invest only in GNMA, FNMA, FHLMC, and Farmer Mac pass-through securities that were collateralized by either: (1) ARMs that reprice within 12 months or less; or (2) fixed-rate mortgages with an absolute final maturity of 5 years. See 56 FR

65691, 65695-65697 (December 18, 1991). The FCC responded with an alternative that would authorize Farm Credit banks to purchase and hold certain GNMA, FNMA, and FHLMC mortgage-derivative securities that satisfied three requirements for limiting interest rate risk in their underlying fixed-rate mortgages. However, the FCC excluded Farmer Mac securities from its proposal. Farmer Mac was silent about how the regulation should treat IRR in these securities.

After careful consideration, the FCA determines that Farmer Mac securities merit a different regulatory treatment concerning IRR than comparable GNMA, FNMA, and FHLMC securities. Except for those rural housing loans that comply with FNMA or FHLMC underwriting standards, Farm Credit banks, as a general rule, lack statutory authority to originate, purchase, or hold the types of residential mortgages that back GNMA, FNMA or FHLMC mortgage-related securities. In contrast, Farmer Mac securities are collateralized with the types of agricultural and rural housing loans that FCBs and ACBs originate, hold, participate in, service, and sell in the normal course of business. As Farmer Mac warned in its comment letter, it would be illogical for the FCA to unduly restrict the ability of Farm Credit banks to hold these securities when they are authorized to originate and hold the underlying loans.

For this reason, the FCA now adopts a regulatory approach that prohibits Farm Credit banks from purchasing and holding Farmer Mac securities that contain greater IRR than the underlying loans. Final § 615.5174 requires the board of directors to establish the maximum level of interest rate risk exposure that the bank shall incur from Farmer Mac MBSs, CMOs and REMICs that are backed by fixed-rate mortgages. This regulation permits boards of directors to adopt conservative policies which significantly limit their banks' exposure to IRR from guaranteed Farmer Mac securities. For example, Farm Credit banks may adopt the standards that § 615.5140(a)(2)(iii) applies to GNMA, FNMA, and FHLMC mortgage-related securities.

Final § 615.5174(e)(1) requires the board of each Farm Credit bank to define the maximum acceptable level of IRR for guaranteed Farmer Mac securities by the: (1) Expected WAL of these securities; (2) maximum number of years that the expected WAL of these instruments will extend or shorten assuming an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points; and (3) maximum change in the price of these

securities due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

The FCA's policy modifies the three-pronged FFIEC test for gauging IRR in mortgage derivative products that are backed by fixed-rate mortgages. Essentially, the FFIEC test determines the point where mortgage derivative products assume greater IRR than an underlying pool of 30-year fixed-rate loans by measuring each security for its: (1) WAL; (2) WAL sensitivity to a 300-basis point shift in interest rates; and (3) price sensitivity to a 300-basis point change in interest rates. See 57 FR 4028, 4038-39 (February 3, 1992).

As stated earlier, final § 615.5174 forbids Farm Credit banks from incurring greater IRR from guaranteed Farmer Mac securities than from the underlying loans. Since the IRR of stripped MBSs and residuals typically exceeds the IRR of the underlying mortgages, § 615.5174(c) prohibits Farm Credit banks from investing in these types of Farmer Mac securities under any circumstances.

For guaranteed Farmer Mac CMOs and REMICs that are exclusively collateralized by fixed-rate, rural housing loans, final § 615.5174(e)(3) states that no Farm Credit bank shall be exposed to IRR beyond the level where: (1) The expected WAL of security exceeds 10 years; (2) the expected WAL of the security extends by more than 4 years, assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points, or shortens by more than 6 years assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points; or (3) the estimated change in the price of the security is more than 17 percent due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points. Section 615.5174(e)(3) derives from the FFIEC standards. This FFIEC test, which is based on the historical experience of the secondary residential mortgage market, demarcates where a mortgage derivative product exhibits greater price volatility than a benchmark, fixed-rate, 30-year residential, mortgage-backed pass-through security. See 57 FR 4028, 4038 (February 3, 1992).

The FCA determines that this three-pronged FFIEC approach is also appropriate for guaranteed Farmer Mac CMOs and REMICs that are backed by fixed-rate agricultural mortgages. However, since this secondary market is not sufficiently developed at the present time, there is no publicly available benchmark data which pinpoints the WAL, WAL sensitivity, and price sensitivity thresholds for agricultural

mortgage-related securities. These three criteria determine where the IRR of a CMO or REMIC surpasses the IRR of the underlying loans. As the secondary market for agricultural mortgages develops over time, market participants and the regulatory agencies will eventually assemble, process and disseminate information which profiles the sensitivity of agricultural real estate loans to interest rate fluctuations. In the interim, final § 615.5174(e)(2) requires Farm Credit banks to apply the three-pronged test in § 615.5174(e)(1), and determine, on a case-by-case basis, whether the IRR of a Farmer Mac security backed by fixed-rate agricultural mortgages exceeds the IRR of the underlying loans.

The FCA's approach toward guaranteed Farmer Mac securities is similar to the treatment that other Federal financial institution regulators accord to securities which are collateralized by residential mortgages that commercial banks, savings associations, and credit unions routinely originate in their capacity as primary lenders.

Final § 615.5174(e)(4) addresses situations where, subsequent to purchase, a guaranteed Farmer Mac security no longer complies with the board of directors' IRR policy. This provision requires portfolio managers to report to the bank's board of directors about the status of those Farmer Mac securities which contain interest rate risk exposure in excess of the board's policy under § 615.5174(e)(1). Furthermore, the portfolio managers shall recommend to the board a comprehensive strategy for preventing the security from causing loss to the bank's capital and earnings. This regulation requires the board of directors of each FCB, BC, or ACB to approve and implement a plan (including any amendments thereto) for preventing loss to the bank's capital and earnings.

The FCA emphasizes that § 615.5174(e)(4) does not compel the bank to divest of Farmer Mac securities which, subsequent to purchase, develop interest rate risk in excess of the level authorized by board policy, provided that there are other options for insulating the bank's capital and earnings from loss. The accounting treatment for guaranteed Farmer Mac securities is governed by SFAS No. 115, for fiscal years beginning after December 15, 1993. The application of SFAS No. 115 to bank investments was discussed in detail in Section X of the preamble.

As long as the guaranteed Farmer Mac security remains in the bank's portfolio, the portfolio managers shall report, at

least quarterly, to the board about changes in the status of the investment, and progress toward containing loss. All of the bank's documentation concerning its strategy to prevent such securities from causing loss to the bank's capital and earning shall be available for review by the Office of Examination at the FCA.

XI. Miscellaneous

The FCA received no comments about proposed § 615.5141, which addresses investment activities by FCS associations, and proposed § 615.5173, which would explicitly authorize Farm Credit banks and associations to purchase and hold Class B common stock of Farmer Mac pursuant to section 8.4 of the Act. The FCA now adopts § 615.5173 as a final regulation without any revision. The FCA now makes a technical correction to § 615.5141 so that the final regulation reflects the statutory authority of ACBs to supervise the investment activities of their affiliated associations. References to the ACBs were inadvertently excluded from the proposed regulation. Additionally, the FCA's proposal to rename subpart F as "Property and Other Investments" and to redesignate § 615.5150 as § 615.5170, § 615.5151 as § 615.5171, and § 615.5160 as § 615.5172 elicited no comments. Accordingly, these amendments are now incorporated into the final regulations. Subpart F shall contain final §§ 615.5170, 615.5171, 615.5172, 615.5173, and 615.5174.

The FCC sought a technical amendment to proposed § 615.5131(h), which defines the term "loans." Under the proposed regulation, Farm Credit banks would use the average daily balance of loans outstanding for the previous 90 days to calculate, every quarter, the investment-to-loan ratio under § 615.5132. The commenter asserted that this calculation should be based on the average daily balance of loans outstanding for the quarter then ended, rather than the previous 90 days, because a quarter may not necessarily correspond to a 90-day cycle. The FCA incorporates this revision into final (and redesignated § 615.5131(i)) because it enhances the clarity of the regulation.

List of Subjects in 12 CFR Part 615

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

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

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

1. The authority citation for part 615 is revised 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, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 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, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b-6, 2279aa, 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. The heading of subpart E is revised to read as follows:

Subpart E—Investment Management

§§ 615.5141 and 615.5142 [Removed]

3. Subpart E is amended by removing §§ 615.5141 and 615.5142.

4. A new § 615.5131 is added to subpart E to read as follows:

§ 615.5131 Definitions.

(a) *Absolute final maturity* means the date on which the remaining principal amount of a mortgage-backed security or asset-backed security is due and payable (matures) to the registered owner. It shall not mean the average life, the expected average life, the duration, or the weighted average maturity.

(b) *Adjustable rate mortgage (ARM)* means a mortgage-backed security that features a predetermined adjustment of the interest rate at regular intervals tied to an index.

(c) *Asset-backed security (ABS)* means investment securities that provide for ownership of a fractional undivided interest, or collateral interests, in a specific asset of a trust that are sold and traded in the capital markets. For the purposes of this subpart, all eligible ABSs shall be collateralized with either loans for the sale of automobiles (CARs) or credit card receivables (CARDs).

(d) *Asset/liability management* means the process used to plan, acquire, and direct the flow of funds through a Farm Credit bank in order to generate adequate and stable earnings and to steadily build equity, while taking reasonable and measured business risks.

(e) *Collateralized mortgage obligation (CMO)* means a multi-class, pay-through bond representing a general obligation of the issuer backed by mortgage collateral. Each CMO consists of a set of, at least, four tranches of bonds with different maturities and cashflow patterns. An accrual bond is last tranche. *Floating Rate CMO* means a CMO or REMIC tranche that pays an

adjustable rate of interest that is tied to a representative interest rate index.

(f) *Federal funds* means funds sold to or bought from a federally insured depository institution or government-sponsored enterprise for 1 business day which increases or decreases that institution's reserve account of immediately available funds with a Federal Reserve Bank. *Term Federal funds* means funds sold to or bought from a federally insured depository institution or government-sponsored enterprise under a callable contract with a term to maturity of 100 days or less.

(g) *Interest rate risk* means the risk of loss resulting from the impact of interest rate fluctuations upon the net interest income and market value of equity of a bank.

(h) *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.

(i) *Loans* is defined as in § 621.2(a)(13) of this chapter, and is calculated quarterly (as the last day of March, June, September, and December) by using the average daily balance of loans for the quarter then ended.

(j) *Marketable investment* is 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.

(k) *Market value of equity* measures the impact that interest rate changes have upon the market value of the bank's assets, liabilities and off-balance-sheet items.

(l) *Mortgage-backed securities (MBSs)* means investment securities collateralized with mortgage loans. MBSs provide for ownership of a fractional undivided interest in a specific pool of mortgages. Each MBS has a stated maturity, weighted average maturity, and coupon rate.

(m) *Negotiable certificates of deposit* means a negotiable large-denomination time deposit with a specific maturity, as evidenced by definitive or book-entry form. *Yankee certificate of deposit* means a certificate of deposit issued in the United States by the American branch of a foreign bank. *Eurodollar certificate of deposit* means a certificate of 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.

(n) *Net interest income* means the difference between interest income and interest expense.

(o) *Prime commercial paper* means a secured or unsecured promissory note of a corporation with a fixed maturity of no more than 270 days that is rated A-1 or P-1 or an equivalent rating by a nationally recognized credit rating service.

(p) *Real estate mortgage investment conduit (REMIC)* means a nontaxable entity (created under the Tax Reform Act of 1986) formed for the sole purpose of holding a fixed pool of mortgages (both residential and commercial) secured by an interest in real property and issuing multiple classes of interests in the underlying mortgages.

(q) *Repurchase agreement* means a transaction where any Farm Credit Bank, bank for cooperatives, or agricultural credit bank agrees to purchase a security from a counterparty and to subsequently sell the same or identical security back to that counterparty for a specified price with a term to maturity of 100 days or less.

(r) *Stripped mortgage-backed securities* means 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. In their purest form, stripped mortgage-backed securities represent mortgage-backed securities that have been converted into interest-only (IO) securities, where the investor receives 100 percent of the interest flows, and principal-only (PO) securities, where the investor receives 100 percent of the principal cashflows.

(s) *Residual* means a "residual" interest tranche from a CMO or REMIC security that collects any cashflows remaining from the collateral after the obligations to the other tranches have been met.

(t) *Total capital* is defined as in Subpart H—Capital Adequacy, § 615.5201(l) of this chapter.

(u) *Weighted average maturity (WAM)* means the weighted average number of months to the final payment of each loan backing a mortgage security, weighted by the size of the principal loan balances.

(v) *Weighted average life (WAL)* means the average time to receipt of principal, weighted by the size of each principal payment. Weighted average life for CMOs and mortgage-backed securities is calculated under some specific prepayment assumptions.

5. The following sections in part 615 are redesignated as set forth in the table below:

REDESIGNATION TABLE

Existing section	New section	New subpart
615.5135(a)	615.5132	E
615.5135(b)	615.5133	E
615.5150	615.5170	F
615.5151	615.5171	F
615.5160	615.5172	F
615.5180	615.5141	E

6. Newly designated §§ 615.5132 and 615.5133 are revised to read as follows:

§ 615.5132 Investment purposes.

Farm Credit Banks, banks for cooperatives and agricultural credit banks are authorized to hold eligible investments, listed under § 615.5140, in an amount not to exceed 30 percent of the total outstanding loans of such banks, for the purposes of complying with the liquidity reserve requirement of § 615.5134, managing surplus short-term funds, and for managing interest rate risk under § 615.5135.

§ 615.5133 Investment management.

The board of directors of each Farm Credit Bank, bank for cooperatives, or agricultural credit bank shall adopt written policies regarding the management of the bank's investments that are consistent with the Farm Credit Act of 1971, Farm Credit Administration regulations, and all other applicable statutes and regulations. The board of directors shall also ensure that the bank's investments are safely and soundly managed in accordance with these written policies, and that appropriate internal controls are in place to preclude investment actions that undermine the solvency and liquidity of the bank. The board of directors shall not delegate its responsibility to oversee and review the investment practices of the bank. The board of directors of each Farm Credit Bank, bank for cooperatives, or agricultural credit bank shall, on an annual basis, review these policies, as well as the objectives and performance of the investment portfolio. At a minimum, the written policy should address:

(a) The purpose and objectives of the bank's investment portfolio;

(b) The liquidity needs of the bank pursuant to the requirements of § 615.5134;

(c) Interest rate risk management pursuant to § 615.5135;

(d) Permissible brokers, dealers, and institutions for investing bank funds and limitations consistent with § 615.5140 of this subpart, and the amount of funds that shall be invested

or placed with any broker, dealer or institution;

(e) The size and quality of the investment portfolio;

(f) Risk diversification of the investment portfolio;

(g) Delegation of authority to manage bank investments to specific personnel or committees and a statement about the extent of their authority and responsibilities;

(h) Controls to monitor the performance of the bank's investments and to prevent loss, fraud, embezzlement, and unauthorized investments. Quarterly reports about the performance of all investments in the portfolio shall be made to the board of directors.

(i) Controls on investments in MBSs, CMOs, REMICs, and ABSs that are consistent with either §§ 615.5140(a)(2) or 615.5140(a)(8)(ii) of this subpart, as applicable, including parameters concerning the maximum amount of exposure to each category in the investment portfolio, minimum pool sizes, minimum number of loans in a pool, geographic diversification of loans in a pool, maximum allowable premiums (particularly as related to CMOs, REMICs, and ARMs).

7. Sections 615.5134, 615.5135 and 615.5136 are added to read as follows:

§ 615.5134 Liquidity reserve requirement.

(a) Each Farm Credit Bank, bank for cooperatives, and agricultural credit bank shall use cash and the eligible investments under § 615.5140 of this subpart to maintain liquidity sufficient to fund:

(1) Fifty (50) percent of the bank's bonds, notes, Farm Credit Investment Bonds, and interest due within the next 90 days divided by 3;

(2) Fifty (50) percent of the bank's discount notes due within the next 30 days; and

(3) Fifty (50) percent of the bank's commercial bank borrowing due within the next 30 days.

(b) Each Farm Credit Bank, bank for cooperatives, and agricultural credit bank shall separately identify all investments that are held for the purpose of meeting its liquidity reserve requirement under this section. All investments held in the liquidity reserve shall be free of lien.

(c) The liquidity reserve requirement shall be calculated as of the last day of each month utilizing month end data.

§ 615.5135 Management of interest rate risk.

The board of directors of each Farm Credit Bank, bank for cooperatives, and agricultural credit bank shall adopt an

interest rate risk management section of an asset/liability management policy which establishes interest rate risk exposure limits as well as the criteria to determine compliance with these limits. At a minimum, the interest rate risk management section shall establish policies and procedures for the bank to:

(a) Identify and analyze the causes of risks within its existing balance sheet structure;

(b) Measure the potential impact of these risks on projected earnings and market values by conducting interest rate shock tests and simulations of multiple economic scenarios at least on a quarterly basis.

(c) Explore and implement actions needed to obtain its desired risk management objectives;

(d) Document the objectives that the bank is attempting to achieve by purchasing eligible investments that are authorized by § 615.5140 of this subpart;

(e) Evaluate and document, at least quarterly, whether these investments have actually met the objectives stated under paragraph (d) of this section.

§ 615.5136 Emergencies impeding normal access of Farm Credit banks to capital markets.

An emergency shall be deemed to exist whenever a financial, economic, agricultural or national defense crisis could impede the normal access of Farm Credit banks to the capital markets.

Whenever the Farm Credit Administration determines after consultations with the Federal Farm Credit Banks Funding Corporation that such an emergency exists, the Farm Credit Administration Board shall, in its sole discretion, adopt a resolution that:

(a) Increases the amount of eligible investments that Farm Credit Banks, banks for cooperatives and agricultural credit banks are authorized to hold pursuant to § 615.5132 of this subpart; and/or

(b) Modifies or waives the liquidity reserve requirement in § 615.5134 of this subpart.

8. Section 615.5140 is amended by revising the section heading and paragraph (a); redesignating paragraph (b) as paragraph (d); and adding new paragraphs (b) and (c) to read as follows:

§ 615.5140 Eligible investments and risk diversification.

(a) In order to comply with §§ 615.5132, 615.5134, and 615.5135 of this subpart, each Farm Credit Bank, bank for cooperatives, and agricultural credit bank is authorized to hold the following eligible investments, denominated in United States dollars:

(1) Obligations of the United States and obligations, other than mortgage-

backed securities, issued and guaranteed as to both principal and interest by an agency or instrumentality of the United States;

(2) Mortgage-backed securities (MBSs), as defined by § 615.5131(f), Collateralized Mortgage Obligations (CMOs), as defined by § 615.5131(e), and Real Estate Mortgage Investment Conduits (REMICs), as defined by § 615.5131(p), that comply with the following requirements:

(i) The MBS, CMO, or REMIC shall either be:

(A) Issued by the Government National Mortgage Association or be backed solely by mortgages that are guaranteed as to both principal and interest by the full faith and credit of the United States; or

(B) Issued by and guaranteed as to both principal and interest by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation and be rated not lower than AAA (or equivalent) by a nationally recognized credit rating service;

(ii) Securities that are backed by adjustable rate mortgages, as defined by § 615.5131(b), shall have a repricing mechanism of 12 months or less tied to an index.

(iii) CMOs, REMICs, and fixed-rate MBSs shall satisfy the following three tests at the time of purchase and each quarter thereafter:

(A) The expected weighted average life (WAL) of the instrument does not exceed 5 years;

(B) 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; and

(C) The estimated change in price is not more than 10 percent due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

In applying the tests of paragraphs (a)(2)(iii) (A), (B), and (C) of this section, each Farm Credit Bank, bank for cooperatives, or agricultural credit bank shall rely on verifiable information to support all of its assumptions (including prepayment assumptions) concerning the collateral mortgages that back the security. All assumptions that form the basis of the bank's analysis 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 about the MBS, CMO, or REMIC, shall

be documented in writing. The analysis of each security shall be performed prior to purchase, and each quarter subsequent to purchase. If at any time after purchase, a MBS, CMO, or REMIC, no longer complies with any requirement in paragraphs (a)(2)(iii) (A), (B), or (C) of this section, the bank shall divest the security in accordance with § 615.5142 of this part.

(iv) A floating-rate CMO debt class shall not be subject to paragraphs (a)(2)(iii) (A) and (B) of this section if at the time of purchase, or each subsequent quarter, it bears a rate of interest that is below the contractual cap on the instrument.

(v) The following instruments do not qualify as eligible investments for the purpose of this section:

(A) Stripped mortgage-backed securities, as defined in § 615.5131(r), including Interest Only (IO) and Principal Only (PO) classes;

(B) Inverse floating rate debt classes investments.

(vi) MBSs, CMOs, and REMICs that are issued by the Government National Mortgage Association, or are backed solely by mortgages that are guaranteed as to both principal and interest by the full faith and credit of the United States shall not be subject to restrictions on the amount that a bank may hold in its investment portfolio;

(vii) MBSs, CMOs, and REMICs that are issued or guaranteed as to principal and interest by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation shall not exceed 50 percent of the bank's total investment portfolio.

(3) Obligations of the International Bank for Reconstruction and Development (The World Bank);

(4) Bankers acceptances, not to exceed 30 percent of the bank's total investment portfolio;

(5) Negotiable certificates of deposit, as defined in § 615.5131(m), that mature within 1 year or less, in an amount not to exceed 25 percent of the total investment portfolio of any Farm Credit Bank, bank for cooperatives, or agricultural credit bank. Any portion of a domestic or Yankee certificate of deposit that is not insured by either the Federal Deposit Insurance Corporation or the National Credit Union Administration, shall be held in a depository institution that maintains at least a rating of B/C, or its equivalent by a nationally recognized credit rating service. Eurodollar certificates of deposit that are not insured by the Federal or national government of the host country shall be held at banks maintaining a rating of B/C or better, and the country where the account is

located shall receive an AAA rating (or equivalent) for political and economic stability from a nationally recognized credit rating service;

(6) Federal funds and Term Federal funds, as defined in § 615.5131(f) of this subpart, that are held either in federally insured depository institutions that maintain a rating of B/C or better, or with other government-sponsored enterprises. Federal funds and Term Federal funds shall not exceed 25 percent of the bank's total investment portfolio;

(7) Prime commercial paper, as defined by § 615.5131(o) of this subpart, shall not exceed 30 percent of the bank's total investment portfolio. In the event that the prime commercial paper is issued by a corporation located outside the United States, the country where the corporation is incorporated shall maintain a rating for political and economic stability of AAA or its equivalent by a nationally recognized credit rating service.

(8) Corporate debt obligations and ABSs, not to exceed 15 percent of the bank's investment portfolio, pursuant to the following requirements:

(i) Corporate debt obligations shall:

(A) Maintain at least a rating of AA, or its equivalent, by a nationally recognized credit rating service, and when applicable, the foreign country where the corporate debtor is incorporated shall maintain an AAA rating or its equivalent for political and economic stability;

(B) Qualify as a marketable investment pursuant to § 615.5131(i);

(C) Mature within 5 years or less from the time of purchase;

(D) Not be convertible into equity securities.

(ii) Asset-backed securities, as defined by § 615.5131(c) shall:

(A) Mature within 5 years or less from the time of purchase;

(B) Maintain at least a rating of AAA, or its equivalent, by a nationally recognized credit rating service.

(9) Repurchase agreements, as defined in § 615.5131(q), collateralized by eligible investments authorized by this section that mature within 100 days or less.

(10) Full faith and credit obligations of any State, territory, or possession of the United States, or political subdivision thereof, including any agency, corporation, or instrumentality of any State, territory, possession, or political subdivision thereof, provided that the obligations:

(i) Maintain at least a rating of A, or the equivalent, by a nationally recognized credit rating service;

(ii) Mature within 10 years from the date of purchase; and

(iii) Qualify as marketable investments within the meaning of § 615.5131(j) of this subpart.

(11) Other investments, as authorized by the Farm Credit Administration, that manifest the following characteristics:

(i) A short maturity;

(ii) Qualify as a marketable investment pursuant to § 615.5131(i) of this subpart;

(iii) Maintain a high investment rating by a nationally recognized credit rating service.

(b) Except for eligible investments covered by paragraphs (a)(1) and (2) of this section, each Farm Credit Bank, bank for cooperatives, or agricultural 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.

(c) Each Farm Credit Bank, bank for cooperatives, and agricultural credit bank shall perform ongoing evaluations of all eligible investments held in its portfolio. Each bank shall support its evaluation with the most recent credit rating of each investment by at least one nationally recognized credit rating service.

* * * * *

9. Newly designated § 615.5141 is revised to read as follows:

§ 615.5141 Association investment portfolios.

Each Farm Credit Bank and agricultural credit bank shall review annually as of June 30 or December 31 the investment portfolios of every Federal land bank association, production credit association, agricultural credit association, and Federal land credit association in the district. Associations are authorized to hold eligible investments pursuant to §§ 615.5140 and 615.5174 as authorized by their Farm Credit Bank or agricultural credit bank. Each Farm Credit Bank and agricultural credit bank shall assist the associations in managing their investment portfolios to reduce interest rate risk and to invest surplus short-term funds.

10. A new § 615.5142 is added to read as follows:

§ 615.5142 Disposal of ineligible investments.

(a) Any Farm Credit Bank, bank for cooperatives, or agricultural credit bank that holds investments that are not in compliance with § 615.5140 shall dispose of such investments within 6 months of the effective date of the final regulation unless the director of the Office of Examination approves in

writing a comprehensive written plan to comply with § 615.5140. The Office of Examination shall consider whether the proposed plan will enable the bank to dispose of impermissible investments within a reasonable period of time, without a substantial loss to the earnings or capital of the bank.

(b) Each Farm Credit Bank, bank for cooperatives, or agricultural credit bank shall dispose of investments that complied with § 615.5140 at the time of purchase, but subsequently became ineligible, within 6 months after the date that such investments became ineligible unless the director of the Office of Examination approves in writing a comprehensive written plan to comply with § 615.5140. The Office of Examination shall consider whether the proposed plan will enable the bank to dispose of impermissible investments within a reasonable period of time, without a substantial loss to the earnings or capital of the bank. Prior to the time that the investment is actually divested, the managers of the bank's investment portfolio shall report to the board of directors, at least quarterly, the status of the investment, including the conditions causing ineligibility, and divestiture plans.

11. The heading for subpart F is revised to read as follows:

Subpart F—Property and Other Investments

12. Sections 615.5173 and 615.5174 are added to read as follows:

§ 615.5173 Stock of the Federal Agricultural Mortgage Corporation.

Banks and associations of the Farm Credit System are authorized to purchase and hold Class B common stock of the Federal Agricultural Mortgage Corporation pursuant to section 8.4 of the Farm Credit Act.

§ 615.5174 Mortgage-related securities issued or guaranteed by the Federal Agricultural Mortgage Corporation.

(a) Pursuant to sections 1.5(15), 3.1(13)(A), and 7.2(a) of the Farm Credit Act, Farm Credit Banks, banks for cooperatives, and agricultural credit banks are authorized to purchase and hold 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), that are guaranteed as to both principal and interest by the Federal Agricultural Mortgage Corporation, in an amount that does not exceed 20 percent of the total outstanding loans of such banks.

(b) Eligible securities under paragraph (a) of this section shall be backed by either:

(1) Adjustable rate mortgages, as defined by § 615.5131(b), that have a repricing mechanism of 12 months or less that are tied to an index; or

(2) Fixed-rate mortgages.

(c) Stripped mortgage-backed securities, as defined in § 615.5131(r) of this part, including Interest Only (IO) and Principal Only (PO) classes, and residuals, as defined by § 615.5131(s) are not eligible investments for the purposes of this section;

(d) The board of directors of each Farm Credit Bank, bank for cooperatives, and agricultural credit bank shall adopt written policies and procedures that bank managers shall follow in purchasing, holding and managing eligible mortgage-related securities that are fully guaranteed as to both principal and interest by the Federal Agricultural Mortgage Corporation. Quarterly reports about the performance of all investments in securities that are guaranteed as to both principal and interest by the Federal Agricultural Mortgage Corporation shall be made to the board of directors. The board of directors of each Farm Credit Bank, bank for cooperatives, or agricultural credit bank shall, on an annual basis, review these policies and procedures, as well as the performance of eligible Federal Agricultural Mortgage Corporation securities that such bank holds as an investment pursuant to this section. At a minimum, the written policy should address:

(1) The purpose and objectives of the bank's investment in securities of the Federal Agricultural Mortgage Corporation;

(2) Parameters concerning the size, characteristics, and quality of guaranteed Federal Agricultural Mortgage Corporation securities that the Farm Credit bank shall purchase and hold. At a minimum, this policy should address:

(i) The mix of guaranteed Federal Agricultural Mortgage Corporation securities that are collateralized by qualified agricultural mortgages, rural housing loans, and loans guaranteed by the Farmers' Home Administration pursuant to 7 U.S.C. 1921 *et seq.*

(ii) Product and geographic diversification in the loans that underlie the securities;

(iii) Minimum pool sizes, minimum number of loans in each pool, and maximum allowable premiums for CMOs, REMICs, and ARMs; and

(iv) The mix of guaranteed Federal Agricultural Mortgage Corporation securities that are collateralized by

either fixed-rate loans or adjustable rate loans that reprice at least annually, based on changes in a published index.

(3) Delegation of authority to manage bank investments in guaranteed securities of the Federal Agricultural Mortgage Corporation to specific personnel or committees and a statement about the extent of their authority and responsibility.

(4) Permissible brokers, dealers, and other intermediaries for conducting purchase and sale transactions involving securities that are guaranteed as to principal and interest by the Federal Agricultural Mortgage Corporation;

(5) Controls to monitor the performance of the bank's investments in guaranteed Federal Agricultural Mortgage Corporation securities for the purposes of preventing loss, fraud, embezzlement, and unauthorized investments;

(6) Management of interest rate risk in these securities pursuant to paragraph (e) of this section;

(7) Procedures to prevent losses to the capital and earnings of the bank;

(8) Procedures for the orderly sales of these securities prior to maturity.

(e) Each Farm Credit Bank, bank for cooperatives, and agricultural credit bank shall manage interest rate risk inherent in guaranteed mortgage-related securities of the Federal Agricultural Mortgage Corporation pursuant to the written policy that its board of directors adopts under paragraph (c)(5) of this section, subject to the following requirements:

(1) The policy of the board of directors shall establish, pursuant to the following formula, the maximum level of interest rate risk exposure that the bank shall incur from CMOs and REMICs that are backed by fixed-rate mortgages:

(i) The expected weighted average life (WAL) of the instrument;

(ii) The maximum number of years that the expected WAL of these instruments will extend assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points, or shorten assuming an immediate and sustained parallel shift in the yield curve of minus 300 basis points; and

(iii) The maximum change in the price of these securities due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

(2) For CMOs and REMICs that are guaranteed as to principal and interest by the Federal Agricultural Mortgage Corporation, and are collateralized by fixed-rate agricultural loans, the board

of directors of each Farm Credit bank shall implement a policy, pursuant to the requirements of paragraph (e)(1) of this section, where at the time of purchase or any quarter thereafter, the interest rate risk of the security never exceeds the interest rate risk in the underlying mortgages.

(3) For CMOs and REMICs that are guaranteed as to principal and interest by the Federal Agricultural Mortgage Corporation, and are exclusively collateralized by fixed-rate rural housing loans, the board of directors of each Farm Credit bank shall not, under any circumstances, implement a policy pursuant to paragraph (d)(1) of this section where, at the time of purchase or each quarter thereafter:

(i) The expected WAL of security exceeds 10 years;

(ii) The expected WAL of the security extends by more than 4 years, assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points, or shortens by more than 6 years assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points; or

(iii) The estimated change in the price of the security is more than 17 percent due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

(4) If at any time subsequent to purchase, a mortgage-related security that is guaranteed as to both principal and interest by the Federal Agricultural Mortgage Corporation no longer complies with the interest rate risk policy that the bank's board of directors adopted under paragraph (d)(1) of this section:

(i) The portfolio managers shall report to the board of directors about the status of the investment, and the conditions that are causing excessive interest rate risk in the security. The portfolio managers shall also recommend to the board of directors a comprehensive plan to prevent loss to the bank's capital and earnings.

(ii) The board of directors of each Farm Credit bank shall adopt and implement a comprehensive policy to prevent the investment from causing loss to the bank's capital and earnings. Any amendment to the plan shall also be approved by the bank's board of directors;

(iii) Until the security is actually divested, the portfolio managers shall report to the board of directors, at least quarterly, about changes in the status of the investment, and the effect of the policy to prevent loss to the bank's capital and earnings.

(iv) All documentation regarding the formulation, adoption, implementation,

and revision of the plan to prevent the security from causing loss to the bank's capital and earnings shall be available for review by the Office of Examination of the Farm Credit Administration.

Dated: November 18, 1993.

Curtis M. Anderson,
Secretary, Farm Credit Administration Board.
[FR Doc. 93-29138 Filed 11-29-93; 8:45 am]
BILLING CODE 6705-01-P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. 93-NM-191-AD; Amendment 39-8748; AD 93-23-12]

Airworthiness Directives; Learjet Inc. Model 60 Airplanes

AGENCY: Federal Aviation Administration, DOT.

ACTION: Final rule; request for comments.

SUMMARY: This amendment adopts a new airworthiness directive (AD) that is applicable to all Learjet Model 60 airplanes. This action requires deactivation of the auxiliary cabin and cockpit heating systems and installation of placards. This amendment is prompted by a report of a fire in the aft fuselage, resulting from miswiring that was installed in an auxiliary cabin heater during manufacture. The actions specified in this AD are intended to prevent overheating of the auxiliary cabin and cockpit heaters, which could potentially result in a fire.

DATES: Effective December 15, 1993.

The incorporation by reference of certain publications listed in the regulations is approved by the Director of the Federal Register as of December 15, 1993.

Comments for inclusion in the Rules Docket must be received on or before January 31, 1994.

ADDRESSES: Submit comments in triplicate to the Federal Aviation Administration (FAA), Transport Airplane Directorate, ANM-103, Attention: Rules Docket No. 93-NM-191-AD, 1601 Lind Avenue SW., Renton, Washington 98055-4056.

The service information referenced in this AD may be obtained from Learjet Inc., P.O. Box 7707, Wichita, Kansas 67277-7707. This information may be examined at the FAA, Transport Airplane Directorate, 1601 Lind Avenue SW., Renton, Washington; or at the FAA, Small Airplane Directorate, Wichita Aircraft Certification Office

(ACO), 1801 Airport Road, Room 100, Mid-Continent Airport, Wichita, Kansas; or at the Office of the Federal Register, 800 North Capitol Street NW., suite 700, Washington, DC.

FOR FURTHER INFORMATION CONTACT: C. Dale Bleakney, Aerospace Engineer, Systems and Equipment Branch, ACE-130W, FAA, Small Airplane Directorate, Wichita ACO, 1801 Airport Road, room 100, Mid-Continent Airport, Wichita, Kansas 67209; telephone (316) 946-4135; fax (316) 946-4407.

SUPPLEMENTARY INFORMATION: The FAA has recently received a report of a fire that broke out in the aft fuselage of a Learjet Model 60 airplane during regularly scheduled ground maintenance of the airplane. A short circuit occurred in the thermal fuses, which allowed electrical current to continue to flow to the auxiliary cabin and cockpit heaters. The heaters apparently had been wired incorrectly during manufacture; therefore, when overheating occurred, the fan turned off, but the heating elements still received power. The airplane manufacturer has confirmed other cases in its fleet of miswiring of these heaters during manufacture. Normally, these heaters are wired in such a manner that they will only operate on the ground. However, in light of this incident, it is possible that a miswired heater could operate while a Model 60 airplane is in-flight. This condition, if not corrected, could result in overheating of the auxiliary cabin and cockpit heaters, which could potentially result in a fire.

The FAA has reviewed and approved Learjet Alert Service Bulletin SB A60-21-1, dated November 1, 1993, that describes procedures for deactivation of the auxiliary cabin and cockpit heating systems and installation of a placard that reads, "Cabin and Cockpit Heat Inop." The deactivation procedure entails disconnecting the electrical connectors or wiring to the auxiliary cabin and cockpit heaters. Accomplishment of this procedure will prevent overheating of the auxiliary cabin and cockpit heaters.

Since an unsafe condition has been identified that is likely to exist or develop on other Model 60 airplanes of the same type design, this AD is being issued to prevent overheating of the auxiliary cabin and cockpit heaters, which could potentially result in a fire. This AD requires deactivation of the auxiliary cabin and cockpit heating systems and installation of a placard stating, "Cabin and Cockpit Heat Inop." The actions are required to be accomplished in accordance with the service bulletin described previously.

Since a situation exists that requires the immediate adoption of this regulation, it is found that notice and opportunity for prior public comment hereon are impracticable, and that good cause exists for making this amendment effective in less than 30 days.

Comments Invited

Although this action is in the form of a final rule that involves requirements affecting flight safety and, thus, was not preceded by notice and an opportunity for public comment, comments are invited on this rule. Interested persons are invited to comment on this rule by submitting such written data, views, or arguments as they may desire. Communications shall identify the Rules Docket number and be submitted in triplicate to the address specified under the caption "ADDRESSES." All communications received on or before the closing date for comments will be considered, and this rule may be amended in light of the comments received. Factual information that supports the commenter's ideas and suggestions is extremely helpful in evaluating the effectiveness of the AD action and determining whether additional rulemaking action would be needed.

Comments are specifically invited on the overall regulatory, economic, environmental, and energy aspects of the rule that might suggest a need to modify the 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 AD 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 Number 93-NM-191-AD." The postcard will be date stamped and returned to the commenter.

The regulations adopted herein will not have substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Therefore, in accordance with Executive Order 12612, it is determined that this final rule does not have sufficient federalism implications to warrant the preparation of a Federalism Assessment.

The FAA has determined that this regulation is an emergency regulation that must be issued immediately to

correct an unsafe condition in aircraft, and is not a "significant regulatory action" under Executive Order 12866. It has been determined further that this action involves an emergency regulation under DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979). If it is determined that this emergency regulation otherwise would be significant under DOT Regulatory Policies and Procedures, a final regulatory evaluation will be prepared and placed in the Rules Docket. A copy of it, if filed, may be obtained from the Rules Docket at the location provided under the caption ADDRESSES.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

Adoption of the Amendment

Accordingly, pursuant to the authority delegated to me by the Administrator, the Federal Aviation Administration amends 14 CFR part 39 of the Federal Aviation Regulations as follows:

PART 39—AIRWORTHINESS DIRECTIVES

1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. App. 1354(a), 1421 and 1423; 49 U.S.C. 106(g); and 14 CFR 11.89.

§ 39.13 [Amended]

2. Section 39.13 is amended by adding the following new airworthiness directive:

93-23-12 Learjet Inc.: Amendment 39-8748. Docket 93-NM-191-AD.

Applicability: All Model 60 airplanes, certificated in any category.

Compliance: Required as indicated, unless accomplished previously.

To prevent overheating of the auxiliary cabin and cockpit heaters, which could potentially result in a fire, accomplish the following:

(a) Within 10 flight hours after the effective date of this AD, deactivate the auxiliary cabin and cockpit heating systems; and install a placard stating, "Cabin and Cockpit Heat Inop" adjacent to the AUX HT Switch (S44) on the co-pilot's switch panel; in accordance with Learjet Alert Service Bulletin SB A60-21-1, dated November 1, 1993.

(b) An alternative method of compliance or adjustment of the compliance time that provides an acceptable level of safety may be used if approved by the Manager, Wichita Aircraft Certification Office (ACO), FAA, Small Airplane Directorate. Operators shall submit their requests through an appropriate FAA Principal Maintenance Inspector, who may add comments and then send it to the Manager, Wichita ACO.

Note: Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the Wichita ACO.

(c) Special flight permits may be issued in accordance with FAR 21.197 and 21.199 to operate the airplane to a location where the requirements of this AD can be accomplished.

(d) The deactivation and placard installation shall be done in accordance with Learjet Alert Service Bulletin SB A60-21-1, dated November 1, 1993. This incorporation by reference was approved by the Director of the Federal Register in accordance with 5 U.S.C. 552(a) and 1 CFR part 51. Copies may be obtained from Learjet Inc., P.O. Box 7707, Wichita, Kansas 67277-7707. Copies may be inspected at the FAA, Transport Airplane Directorate, 1601 Lind Avenue, SW., Renton, Washington; or at the FAA, Wichita ACO, 1801 Airport Road, Room 100, Mid-Continent Airport, Wichita, Kansas; or at the Office of the Federal Register, 800 North Capitol Street, NW., suite 700, Washington, DC.

(e) This amendment becomes effective on December 15, 1993.

Issued in Renton, Washington, on November 22, 1993.

Darrell M. Pederson,

Acting Manager, Transport Airplane Directorate, Aircraft Certification Service.

[FR Doc. 93-29100 Filed 11-29-93; 8:45 am]

BILLING CODE 4910-13-P

14 CFR Part 39

[Docket No. 93-ANE-58; Amendment 39-8745; AD 93-23-09]

Airworthiness Directives; Turbomeca Arriel 1 Series Turboshaft Engines

AGENCY: Federal Aviation Administration, DOT.

ACTION: Final rule, request for comments.

SUMMARY: This amendment adopts a new airworthiness directive (AD) that is applicable to certain Turbomeca Arriel 1 series turboshaft engines. This action requires repetitive checks for engine rubbing noise during gas generator shutdown, and for free rotation of the gas generator by rotating the compressor manually after the last flight of the day. This amendment is prompted by a report of an engine failure due to cracking and axial movement of the 2nd stage nozzle guide vane causing a rub with the 2nd stage turbine disk. The actions specified in this AD are intended to prevent engine failure due to rubbing of the 2nd stage turbine nozzle guide vane with the 2nd stage turbine disk, which could result in complete engine failure and damage to the aircraft.

DATES: Effective December 15, 1993.

The incorporation by reference of certain publications listed in the

regulations is approved by the Director of the Federal Register as of December 15, 1993.

Comments for inclusion in the Rules Docket must be received on or before January 31, 1994.

ADDRESSES: Submit comments in triplicate to the Federal Aviation Administration (FAA), New England Region, Office of the Assistant Chief Counsel, Attention: Rules Docket No. 93-ANE-58, 12 New England Executive Park, Burlington, MA 01803-5299.

The service information referenced in this AD may be obtained from Turbomeca, 64511 Bordes Cedex, France. This information may be examined at the FAA, New England Region, Office of the Assistant Chief Counsel, 12 New England Executive Park, Burlington, MA; or at the Office of the Federal Register, 800 North Capitol Street, NW., suite 700, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Mark Rumizen, Aerospace Engineer, Engine Certification Office, FAA, Engine and Propeller Directorate, 12 New England Executive Park, Burlington, MA 01803-5299; telephone (617) 238-7137, fax (617) 238-7199.

SUPPLEMENTARY INFORMATION: The Direction Generale de L'Aviation Civile (DGAC), which is the airworthiness authority for France, recently notified the Federal Aviation Administration (FAA) that an unsafe condition may exist on certain Turbomeca Arriel 1 series turboshaft engines. The DGAC advises that they have received a report of a Turbomeca Arriel 1B engine failure, which resulted in the crash of an Aerospatiale AS350B helicopter. Turbomeca's investigation revealed that the engine failed due to thermal low cycle fatigue cracking and associated displacement of the 2nd stage turbine nozzle guide vane, which resulted in rubbing with, and failure of, the 2nd stage turbine disk. This condition, if not corrected, could result in engine failure due to rubbing of the 2nd stage turbine nozzle guide vane with the 2nd stage turbine disk, which could result in complete engine failure and damage to the aircraft.

Turbomeca has issued Service Bulletin (SB) No. 292 72 0181, dated July 23, 1993, that specifies checking for engine rubbing noise during gas generator shutdown, and for free rotation of the gas generator by rotating the compressor manually after the last flight of the day. The cracking and axial movement of the 2nd stage nozzle guide vane rubbing with the 2nd stage turbine disk can be detected in advance of failure by determining if a rubbing noise exists during engine coastdown. The