based information tools, although DOE will also work collaboratively with the FTC to determine if changes to Energy Guide labeling requirements would be beneficial to consumers.

DOE agrees with NEEA's comment that the difference between primary energy use estimates and FFC energy use estimates is relatively small. (NEEA, Public Comment, EERE–2010–BT–NOA–0028–0021, p. 2) However, to date, consumers have not had ready access to information on either the primary or FFC energy and emission impacts of products. Making such information available in a manner that would enable consumers to make cross-fuel and cross-class comparisons of comparable products could provide consumers with significant new information.

The Consumer's Union commented that the Energy Guide labels must increase consumer awareness of GHG emissions to effectively educate consumers and engage them in energy and climate change policy. Such labels should ''address regional variation of electricity fuel mixes and provide consumers guidance on how to interpret the data given their region or particular utility.'' (Consumers, Public Comment, EERE–2010–BT–NOA–0028–0028, p. 5) DOE agrees that consumers should be given ready access to better information on the energy resource and environmental impacts of their appliance choices and how to provide this information in a meaningful way will be a significant issue for DOE and the FTC to consider.

Policy Statement: Subject to the availability of funds, DOE will work with other Federal agencies to make readily available to consumers improved information on the energy use, life-cycle cost and associated emissions of comparable products, even if those products use different forms of energy. Consumers should be able to easily identify the likely energy use, life-cycle costs and associated emissions of individual products (based on their local energy costs and utility system characteristics), but should also be able to compare those attributes to a range of other products providing similar utility. In developing betters ways of conveying such information to consumers, DOE will explore the possible role of common efficiency metrics for products using different fuels or energy, and will, as appropriate, solicit further public review and comment on the mechanisms developed to make available this information to consumers.

Any updates to Energy Guide labels will be promulgated by the FTC, which has statutory authority over Energy Guide labels.

IV. Procedural Issues and Regulatory Review

A. Review Under the National Environmental Policy Act of 1969

DOE has determined that this Policy Statement falls into a class of actions that are categorically excluded from review under the National Environmental Policy Act of 1969 (42 U.S.C. 4321 *et seq.*) and DOE's implementing regulations at 10 CFR part 1021. Specifically, this Policy Statement describes methods for data analysis and how DOE plans to incorporate such data analysis into future energy conservation standards. For this reason, and because the Policy Statement does not establish an energy conservation standard or take any action that might have an impact on the environment, it is covered by the Categorical Exclusion A9 under 10 CFR part 1021, subpart D. Accordingly, neither an environmental assessment nor an environmental impact statement is required.

B. Review Under the Information Quality Bulletin for Peer Review

In consultation with the Office of Science and Technology Policy (OSTP), OMB issued on December 16, 2004, its ''Final Information Quality Bulletin for Peer Review'' (the Bulletin). 70 FR 2664 (Jan. 14, 2005). The Bulletin establishes that certain scientific information shall be peer reviewed by qualified specialists before it is disseminated by the Federal government, including influential scientific information related to agency regulatory actions. The purpose of the Bulletin is to enhance the quality and credibility of the government's scientific information. Under the Bulletin, the Academy recommendations and GREET model are ''influential scientific information,'' which the Bulletin defines as ''scientific information that the agency reasonably can determine will have or does have a clear and substantial impact on important public policies or private sector decisions.'' 70 FR 2664, 2667 (Jan. 14, 2005). The Academy recommendations have been peer reviewed pursuant to section II.2 of the Bulletin. The GREET model, which is in the public domain, has been reviewed through its development and applications over the past 16 years.

V. Approval of the Office of the Assistant Secretary

The Assistant Secretary of DOE's Office of Energy Efficiency and Renewable Energy has approved publication of this final policy.

Issued in Washington, DC, on August 10, 2011.

Roland J. Risser,

Program Manager, Building Technologies Program, Energy Efficiency and Renewable Energy.

[FR Doc. 2011–21078 Filed 8–17–11; 8:45 am]

BILLING CODE 6450–01–P

FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052–AC50

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

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, Agency, us, our, or we) proposes to amend our regulations governing investments held by institutions of the Farm Credit System (FCS or System). We propose to strengthen our regulations governing investment management, interest rate risk management, and association investments; revise the list of eligible investments to ensure it is limited only to high-quality, liquid investments; reduce regulatory burden for investments that fail to meet eligibility criteria after purchase or are unsuitable; and make other changes that will enhance the safety and soundness of System institutions. In this proposal, we also seek comments on compliance with section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or DFA), which requires us to remove all references to and requirements relating to credit ratings and to substitute other appropriate standards of creditworthiness. We also seek comment on other issues.

DATES: You may send us comments by November 16, 2011.

ADDRESSES: We offer a variety of methods for you to submit comments on this proposed rule. For accuracy and efficiency reasons, commenters are encouraged to submit comments by e-mail or through the Agency's Web site. As facsimiles (fax) are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act, we are no longer accepting comments submitted by fax. Regardless of the method you use, please do not submit your comment multiple times via different methods. You may submit comments by any of the following methods:

• *E-mail:* Send us an e-mail at *reg-comm@fca.gov.*

• *FCA Web site: http://www.fca.gov.* Select ''Public Commenters,'' then ''Public Comments,'' and follow the directions for ''Submitting a Comment.''

• *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.

• *Mail:* Gary K. Van Meter, Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102–5090.

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

FOR FURTHER INFORMATION CONTACT:

Timothy T. Nerdahl, Senior Financial Analyst, Office of Regulatory Policy, Farm Credit Administration, McLean, VA 22102–5090, (952) 854–7151 extension 5035, TTY (952) 854–2239; or Jennifer A. Cohn, Senior Counsel, Office of General Counsel, Farm Credit Administration, McLean, VA 22102–5090, (703) 883–4020, TTY (703) 883–4020.

SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of this proposed rule are to:

• Ensure that Farm Credit banks [1] hold sufficient high-quality, readily marketable investments to provide sufficient liquidity to continue operations and pay maturing obligations in the event of market disruption;

• Strengthen the safety and soundness of System institutions;

• Discuss the requirements of section 939A of the Dodd-Frank Act;

• Reduce regulatory burden with respect to investments that fail to meet eligibility criteria after purchase or are unsuitable; and

• Enhance the ability of the System to supply credit to agriculture and aquatic producers by ensuring adequate availability to funds.

II. Background

Congress created the System as a Government-sponsored enterprise (GSE) to provide a permanent, stable, and reliable source of credit and related services to American agriculture and aquatic producers. Farm Credit banks obtain funds used by System banks and associations to provide credit and related services primarily through the issuance of System-wide debt securities.[2] If access to the debt market becomes temporarily impeded, Farm Credit banks must have enough readily available funds to continue operations and pay maturing obligations.

Subpart E of part 615 imposes comprehensive requirements regarding the investments of System institutions (primarily Farm Credit banks).[3] Section 615.5134(a) of FCA regulations requires each Farm Credit bank to maintain a specified liquidity reserve.[4] This liquidity reserve may only be funded from cash and eligible investments.[5]

We adopted our last major revisions to our investment regulations in 1999 and amended them in a more limited manner in 2005. Since 1999, the marketplace pertaining to investments has changed significantly. Innovations in investment products have led to their increasing complexity, and investors need to have greater expertise to fully understand them. In addition, the financial crisis that began in 2007 resulted in numerous investment downgrades and the loss of billions of dollars by financial institutions.

While System banks suffered considerably less stress during the crisis than many other financial institutions, they did experience numerous downgrades and some losses on individual investments. In 2010, we issued a bookletter that provides clarification and guidance regarding our regulations and expectations with respect to the key elements of a robust investment asset management framework that institutions should establish to prudently manage their investments in changing markets.[6] The issuance of this bookletter was an interim measure towards strengthening our investment regulations.

In July 2010, the President signed into law the Dodd-Frank Act to strengthen regulation of the financial industry in the wake of the financial crisis that unfolded in 2007 and 2008. As discussed in greater detail below, section 939A of the DFA requires each Federal agency to revise all of its regulations that refer to or require reliance on credit ratings to assess creditworthiness of an instrument to remove the reference or requirement and to substitute other appropriate creditworthiness standards.

We now propose amendments that would strengthen our investment regulations. In addition, in certain areas, including compliance with section 939A of the DFA, we seek comments but propose no specific regulatory revisions. In these areas, we will likely have to propose revisions before we will be able to adopt revisions as final. We will consider all comments received in this or future rulemakings, as appropriate.

III. Section-by-Section Description of the Proposed Rule

Following is a section-by-section description of the proposed revisions to our rules.

A. Section 615.5131—Definitions

We propose to amend § 615.5131 to add two new definitions to reflect clarifications we propose to make to § 615.5140, as discussed below. We propose adding a definition for *Government agency,* which we would define as the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations *are* fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States Government. We also propose adding a definition for *Government-sponsored agency.* We would define this term as an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the United States Congress but whose obligations *are not* explicitly insured or guaranteed by the full faith and credit of the United States Government. This definition would include GSEs such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), as well as Federal agencies, such as the

[1] Section 619.9140 of FCA regulations defines Farm Credit bank to include Farm Credit Banks, agricultural credit banks, and banks for cooperatives.

[2] Farm Credit banks use the Federal Farm Credit Banks Funding Corporation (Funding Corporation) to issue and market System-wide debt securities. The Funding Corporation is owned by the Farm Credit banks.

[3] Section 615.5142 authorizes associations to hold eligible investments with the approval and oversight of their funding banks, for specified purposes. Associations that hold investments, as well as service corporations that hold investments, are subject to our investment management regulation at § 615.5133.

[4] We expect to propose revisions to § 615.5134 in an upcoming rulemaking.

[5] § 615.5134(a).

[6] FCA Bookletter BL–064, *Farm Credit System Investment Asset Management* (December 9, 2010). This Bookletter may be viewed at *http://www.fca.gov.* Under Quick Links, click on Bookletters.

Tennessee Valley Authority, that issue obligations that are not explicitly guaranteed by the Government of the United States' full faith and credit.

B. Section 615.5132—Investment Purposes

In 2005, we modified § 615.5132 to increase the permissible level of investments that Farm Credit banks may hold from 30 to 35 percent of total outstanding loans. The reason for the increase was to provide the banks with additional flexibility to meet their liquidity needs and accomplish their asset/liability management strategies in varying economic conditions. At this time, we continue to believe that the investment maximum of 35 percent of total outstanding loans provides the banks adequate flexibility to maintain their liquidity reserve at an appropriate amount. However, as discussed below, we solicit public comments on this issue.

In this discussion, we emphasize the proper application of a provision of this regulation. We also discuss a proposed revision and an area where we specifically seek the views of commenters.

1. Permissible Investment Purposes

Section 615.5132 permits each Farm Credit bank to hold eligible investments for the purposes of maintaining a liquidity reserve, managing surplus short-term funds, and managing interest rate risk. These purposes do not authorize Farm Credit banks to accumulate investment portfolios for arbitrage activities or to engage in trading for speculative or primarily capital gains purposes.[7] Realizing gains on sales before investments mature is not a regulatory violation as long as the profits are incidental to the specified permissible investment purposes. Farm Credit banks must ensure that their internal controls, required under §§ 615.5133(e) and 618.8430, ensure that eligible investments listed in § 615.5140(a) are limited to those that are appropriate under § 615.5132.

2. Excluding Investments Pledged To Meet Margin Requirements for Derivative Transactions

Section 615.5132 permits Farm Credit banks to hold eligible investments, for specified purposes, in an amount not to exceed 35 percent of its total outstanding loans. We propose to permit banks to exclude investments pledged to meet margin requirements for derivative transactions (collateral) when calculating the 35-percent investment limit. We note that investments that are pledged as collateral do not count toward a Farm Credit bank's compliance with its liquidity reserve requirement.[8] Derivatives are used as a hedging tool against interest rate risk and liquidity risk. Farm Credit banks use derivative products as an integral part of their interest rate risk management activities and as a supplement to the issuance of debt securities in the capital markets. We recognize that banks are required to post collateral to counterparties resulting from entering into derivative transactions, and we believe banks should not be discouraged from implementing appropriate risk management practices.

3. Treasury Securities and the 35-Percent Investment Limit

Historically, Farm Credit banks have invested in instruments that generate yield in excess of the cost of funds (positive carry). Since the recent financial crisis, however, the banks have experienced decreased liquidity with these instruments at times, and they have turned to United States Treasury securities because of their high liquidity.[9] Treasury securities generally have yields that are lower than the cost of the underlying Farm Credit debt that would fund such securities, and this negative carry has an adverse impact on bank earnings.

Under our existing 35-percent investment limit, holding Treasury securities reduces the maximum amount of investments that Farm Credit banks may hold in other eligible securities. Thus, the banks must choose between greater liquidity but a negative carry, or a positive carry but reduced liquidity.[10] Banks would be able to avoid making this choice if they were permitted to exclude a portion of or all Treasuries or to apply a discount to Treasury securities when calculating the 35-percent limit.

We currently believe that the 35-percent limit continues to provide sufficient flexibility for Farm Credit banks to maintain adequate liquidity. However, we have received a request from a System workgroup asking us to consider treating Treasury securities as cash for purposes of this provision.

Consequently, we seek comment on whether and how to address the situation Farm Credit banks face in holding Treasury securities. Are Farm Credit banks able to purchase sufficient Treasury securities to enhance liquidity, while remaining within the constraint that total investments may not exceed 35 percent of total outstanding loans? Or should the percentage be raised and, if so, to what level and why? Should Treasuries be excluded from total investments when calculating the percentage of total investments to total loans outstanding? Would it be appropriate to exclude a portion of Treasury securities from the calculation? Would it be appropriate to apply a discount to Treasuries? What would be the basis for such a calculation change?

C. Section 615.5133—Investment Management

Effective investment management requires financial institutions to establish policies that include risk limits, approved mechanisms for identifying, measuring, and reporting exposures, and strong corporate governance. The recent crisis and its lingering effects have re-emphasized the importance of sound investment management, and we believe that strengthened regulation would further ensure the safe and sound management of investments. Accordingly, we are proposing significant changes to § 615.5133, which governs investment management.[11]

In addition, we propose minor technical, clarifying, and non-substantive language changes to this section that we do not specifically discuss in this preamble.

1. Proposed § 615.5133(a)—Responsibilities of Board of Directors

We propose enhancements to the responsibilities of each board of directors set forth in § 615.5133(a). The existing regulation requires the board to review its investment policies annually and to make any changes that are needed. We believe that depending on the situation, this review may need to occur more than once a year. We would continue to require a review at least annually but, to reduce unnecessary regulatory burden, we propose to permit a designated board committee to conduct this review and to validate the

[7] FCA has consistently taken this position. *See, e.g.,* 70 FR 51587, August 31, 2005; 58 FR 63039, November 30, 1993.

[8] Under § 615.5134(b), all investments that a bank holds for the purpose of meeting the liquidity reserve requirement must be free of lien.

[9] A System workgroup has recommended the establishment of a minimum level of cash and/or investments in Treasury securities as part of the liquidity reserve requirement of Farm Credit banks. FCA expects to propose revisions to § 615.5134, governing this liquidity reserve requirement, in an upcoming rulemaking.

[10] Cash, which is also held for liquidity, also has a negative carry, but it is not subject to the 35-percent investment limit, and so it does not pose the same challenge.

[11] This rule would supersede the guidance contained in Bookletter BL–064.

sufficiency of the investment policies, provided that the board must adopt any changes to the policies.

2. Proposed § 615.5133(b)—Investment Policies—General Requirements

Section 615.5133(b) lists the items that a board's investment policy must address, but it currently does not include every requirement of § 615.5133. For example, existing § 615.5133(e) requires an institution to establish internal controls, and existing § 615.5133(f) requires specified securities valuation, but existing § 615.5133(b) does not require these items to be addressed in the investment policy. Our proposal would require that the investment policy address every requirement of § 615.5133. This revision would clarify our expectations as to the appropriate content of the board's policies.

We would also require that investment policies must address the means for reporting, and approvals needed for, exceptions to established policies. Because the investment policies are established by the board, we believe it is important for the board's policies to address how exceptions to those policies will be handled. We believe exceptions to a policy should be rare, because frequent exceptions call into question the adequacy of the policy.

In addition, we propose that institutions must document in their records or board minutes any analyses used in formulating policies or amendments to the policies. An accurate record of the analysis used to formulate investment policies documents appropriate governance. It also provides a trail for future directors and managers to review to fully understand how previous boards of directors arrived at their decisions and why they approved the policy in the form they did.

3. Proposed § 615.5133(c)—Investment Policies—Risk Tolerance

Our proposed changes are intended to make the investment policies' risk tolerance discussion more robust. In addition to the existing requirements of this section, investment policies would have to establish concentration limits for the various types and sectors of eligible investments and for the entire investment portfolio. We propose to delete the requirement that investment policies must establish diversification requirements, because the new concentration limit requirement would necessarily lead to diversification.

a. Proposed § 615.5133(c)(1)—Credit Risk

Existing § 615.5133(c)(1)(i) provides that investment policies must establish credit quality standards, limits on counterparty risk, and risk diversification standards that limit concentrations based on a single or related counterparty(ies), a geographical area, industries, or obligations with similar characteristics. We propose to clarify that concentration limits be based on either a single or related counterparty(ies). Further, concentration limits must also be based on a geographical area, industries or sectors, asset classes, or obligations with similar characteristics. We believe this amendment would ensure that diversification is more thoroughly considered by System institutions.

Existing § 615.5133(c)(1)(ii) requires investment policies to establish criteria for selecting securities firms. It requires the board annually to review the criteria for selecting securities firms and determine whether to continue existing relationships. To reduce unnecessary regulatory burden, we propose to permit a designated committee of the board to review the criteria and to determine whether to continue existing relationships, but the board must approve any changes to the criteria and any changes to the existing relationships. This change would permit a designated committee to use its technical expertise to assist the board in carrying out its responsibilities.

Existing § 615.5133(c)(1)(iii) requires investment policies to establish collateral margin requirements on repurchase agreements. We propose to require institutions to regularly mark the collateral to market and ensure appropriate controls are maintained over collateral held. We believe it is prudent for institutions to manage potential counterparty risk and to establish appropriate counterparty margin requirements based on the quality of the collateral and the terms of the agreement.

b. Proposed § 615.5133(c)(2)—Market Risk

We propose changes to § 615.5133(c)(2), which relates to market risk. Specifically, we propose to link this regulation to our stress-testing requirements contained in proposed § 615.5133(f)(2), our interest rate risk requirements contained in § 615.5135, and other policies and guidance. These changes clarify our expectations that the board consider all aspects of market risk.

4. Proposed § 615.5133(e)—Internal Controls

We propose to modify our internal controls requirements in § 615.5133(e). In § 615.5133(e)(2), we propose adding additional personnel to the list of personnel whose duties and supervision should be separated from personnel who execute investment transactions. These additional personnel are those who post accounting entries, reconcile trade confirmations, and report compliance with investment policy. We believe this additional separation is a best practice that System institutions should have in place to ensure controls are sufficient and appropriate.

We also propose a new § 615.5133(e)(4). This provision would require each institution to implement an effective internal audit program to review, at least annually, investment controls, processes, and compliance with FCA regulations and other regulatory guidance. The internal audit program would specifically have to include a review of the processes used for ensuring all investments, at the time of purchase, are eligible and suitable for purchase under the board's investment policies and for ensuring investments continue to meet all applicable generally accepted accounting principles even if they are no longer part of the liquidity portfolio.

Existing § 618.8430 requires each institution's board to adopt an internal control policy that provides direction to the institution in establishing effective control over, and accountability for, operations, programs, and resources. Our regulations do not, however, discuss the internal audit of the investment function specifically. However, FCA Bookletter BL–064 provides guidance on FCA expectations in this area. We now propose to strengthen this guidance by adding it as a regulatory requirement in § 615.5133(e)(4).

As we stated in FCA Bookletter BL–064, under § 618.8430 an institution's board is responsible for ensuring that sound systems and controls are in place to manage investment risks. Senior management is responsible for implementing an effective control environment to manage risk in an institution's investment portfolio, as well as to ensure compliance with applicable laws and regulations. Internal audit is a critical function that ensures appropriate internal controls are in place. Accordingly, our proposal would require System institutions to establish internal controls to ensure that an independent review over investment practices and controls, including specifically the process for determining eligibility and suitability, is conducted.

An institution's audit plan must include a risk assessment, at least annually, of the investment function by the internal audit department or by an outside vendor if the expertise in-house does not exist. Moreover, an institution must conduct an internal audit of the investment function at least annually. As we stated in FCA Bookletter BL–064, the frequency and scope of review should be based on the complexity and size of the investment portfolio. In addition, auditors should be rotated to obtain alternate views of investment operations. Outside audits of the portfolio should be conducted periodically as necessary to ensure an objective evaluation of practices and controls by qualified auditors.

5. Proposed § 615.5133(f)—Due Diligence To Determine Eligibility, Suitability, and Value of Investments

We propose to add a new § 615.5133(f). This provision would cover the due diligence institutions must perform to determine eligibility, suitability, and value of investments. This provision would combine in one location the requirements governing securities valuation and those governing stress testing that are now in existing § 615.5133(f) and § 615.5141, respectively. Our proposed revisions would make these requirements more robust and less burdensome.

a. Proposed § 615.5133(f)(1)—Eligibility and Suitability for Purchase

In new § 615.5133(f)(1), we propose that before an institution purchases an investment, it must conduct sufficient due diligence to determine whether the investment is eligible under § 615.5140 and suitable for purchase under the investment policies of the institution's board. We propose to retain from existing § 615.5133(f)(1) the requirement that the institution must verify the value of the investment (unless it is a new issue) with a source that is independent of the broker, dealer, counterparty, or other intermediary to the transaction. We also propose to require that an institution's investment policies must fully address the extent of pre-purchase analysis that management must perform for various classes of investments and that the institution must document its assessment of eligibility and suitability, including the information used in its assessment. The provision would permit the institution to use all available sources, including third party sources, to assess the investment. Finally, the provision would require that the institution's assessment of each investment at the time of purchase must at a minimum include an evaluation of credit risk, liquidity risk, market risk, and interest rate risk, and an assessment of the cash flows and the underlying collateral of the investment.

This proposed regulation builds on our expectations for institutions to conduct proper due diligence, which we conveyed in FCA Bookletter BL–064. System institutions must conduct due diligence prior to purchasing a security. The degree of due diligence that an institution conducts must be commensurate with the complexity of the security. The need to evaluate and make a decision on a transaction quickly does not obviate the due diligence requirement. FCA expects that institutions must thoroughly understand the risks and cash flow characteristics of their investments, particularly for products that have unusual, leveraged, or highly variable cash flows. System institutions must identify and measure risks prior to acquisition. In general, institutions should conduct and document due diligence analyses separately for each investment security. Modeling cash flows and assumptions at the time of purchase provides insight into the changing risks certain investments present.

We believe that documentation of the analysis conducted is a critical component for assessing and verifying eligibility and suitability. Investment policies must require that an adequate level of analysis be conducted on the various classes of investments purchased. Under this proposed regulation, System institutions that engage in investment activity will need to strengthen their due diligence process and improve their documentation as to why the investment was purchased.

We expect that institutions will evaluate each investment they purchase using various sources available to them, including third parties if warranted, to assess whether an investment meets the eligibility requirements. Institutions may not, however, rely exclusively on third parties to justify the purchase of a security. Institutions must always conduct their own due diligence, because management and the board are ultimately responsible for any decisions. Moreover, because of the particular concerns surrounding the accuracy of credit ratings, institutions must be especially cautious if they choose to consider them.

b. Proposed § 615.5133(f)(2)—Pre-Purchase and Quarterly Stress Testing

We propose moving our investment stress-testing requirements into § 615.5133(f)(2), as part of our due diligence and security valuation requirements, and removing existing § 615.5141 as a stand-alone, stress-testing regulation. We propose this change because stress-testing is a key component of due diligence. It is used to assess the risk presented by an investment and the changes in valuation that may be experienced from movements in interest rates. In addition, we propose changes to the substance of the stress-testing requirements.

Existing § 615.5141 requires pre-purchase and quarterly interest rate stress testing for mortgage securities. It provides that mortgage securities are not eligible investments unless they pass a stress test, and it requires divestiture of a mortgage security that no longer complies with the stress-testing requirements.

In the preamble to the 1999 final rule, in which we adopted the existing stress-testing requirements, we stated that we believed stress-testing was an essential risk management practice because even highly rated mortgage securities may expose investors to significant interest rate risk.[12] We therefore stated that ''each System institution needs to employ appropriate analytical techniques and methodologies to measure and evaluate interest rate risk inherent in mortgage securities. More specifically, prudent risk management practices require every System institution to examine the performance of each mortgage security under a wide array of possible interest rate scenarios.'' [13]

Because of the importance of stress testing and the increasing complexity of investments, we propose in a new § 615.5133(f)(2) that all investments—not just mortgage securities, and including Treasury securities—must be stress tested before purchase and on a quarterly basis. This new requirement would enable System institutions to gain insight into the price movements of all securities they purchase. We understand that stress-testing for investments that have indexed rates that reprice at intervals of 12 months or less or have extremely short terms (such as Fed Funds and certain commercial paper) may be viewed as unnecessary. However, we believe that all investments must be stress tested to build a robust stress-testing environment that provides for a comprehensive and consistent analytical framework from which to evaluate the risks in the investment portfolio. It is also an important part of

[12] *See* 64 FR 28893, May 28, 1999.

[13] *Id.*

due diligence and the ongoing evaluation process.

Existing § 615.5141 provides two stress-testing options. In the first option, we set forth a standardized, three-pronged stress test that includes an average life test, an average life sensitivity test, and a price sensitivity test. In the second prong, we permit institutions to use alternative stress-test criteria and methodologies to evaluate the price sensitivity of mortgage securities.

We now propose to eliminate the standardized stress test. Since we first allowed the alternative stress test, we believe that every Farm Credit bank that invests in mortgage securities has moved to the alternative test and that none continue to use the standardized test. We discuss new stress-testing requirements, set forth in § 615.5133(f)(2)(iii), below.

To reduce regulatory burden, we propose in new § 615.5133(f)(2)(i) that an institution may purchase, with board approval, an investment that exceeds the stress-test parameters defined in its board's policies. We believe this flexibility is necessary because the financial markets continue to be very dynamic and a particular investment may not meet a board's parameters but may nevertheless provide additional liquidity or interest risk protection.

We propose in new § 615.5133(f)(2)(ii) that at the end of each quarter, each institution must stress test its entire investment portfolio, including a stress test of each individual investment, in accordance with paragraph (f)(2)(iii), as defined in its board policy. An investment that exceeds the board-defined stress parameters would not become ineligible and would not need to be divested. Rather, the board policy defining the stress tests would have to specify what actions the institution would take if its portfolio (but not an individual investment) exceeded the quarter-end, stress-test parameters defined in the policy, including the development of a plan to bring the portfolio back into compliance with those parameters.

We believe that stress testing the entire investment portfolio at each quarter-end will provide significant insight into the risks associated with the investment portfolio. We also believe that requiring the stress testing of individual investments on a quarterly basis is just a component of understanding how each individual investment affects the entire portfolio. Should an institution's entire portfolio exceed its board's stress-testing policy parameters it would have to develop a plan to bring the portfolio back into compliance. This plan should specify how the institution would bring the portfolio back into compliance and what timeframes are involved.

As discussed below, in § 615.5133(g)(2) we propose to require an institution to provide immediate notification to the board or a designated board committee if its stress test for the entire portfolio exceeds its board's policy parameters. We believe that a portfolio stress test that exceeds board parameters discloses a serious situation that could threaten the safety and soundness of the institution and that directors should be notified and a plan developed to reduce portfolio risk.

Proposed § 615.5133(f)(2)(iii) sets forth the requirements for pre-purchase and quarter-end stress tests. These requirements are for the most part unchanged from our existing requirements in § 615.5141 governing the alternative stress test. We discuss the differences below.

Proposed § 615.5133(f)(2)(iii) would require that the pre-purchase and quarter-end stress tests be defined in a board approved policy and include defined parameters for the types of securities an institution purchases. The stress tests would have to be comprehensive and appropriate for the risk profile of the institution. At a minimum, the stress tests would have to be able to measure the price sensitivity of investments over different interest rate/yield curve scenarios. The methodology that the institution uses to analyze investment securities would have to be appropriate for the complexity, structure, and cash flows of the investments in its portfolio.

The stress tests would have to enable the institution to determine at the time of purchase and each subsequent quarter-end that its investment securities, either individually or on a portfolio-wide basis, do not expose its capital, earnings, or liquidity to excessive risks. Also, the stress tests would have to enable the institution to evaluate the overall risk in the investment portfolio and compare it with defined board policy limits.

Two of the new requirements in this proposal—the requirement that all securities, not just mortgage securities, must be stress tested; and the requirement that securities must be stress tested on a portfolio-wide basis—are discussed above. The other new requirement is that stress tests would have to enable an institution to determine that its investment securities do not expose it to excessive liquidity risk. We propose this requirement because we believe an institution should have insight into the amount of cash it could obtain through the sale of investments, if necessary.

In conducting its stress tests, an institution would have to rely, to the maximum extent practicable, on verifiable information to support all of its assumptions, including prepayment and interest rate volatility assumptions, when applying its stress tests. An institution would have to document the basis for all assumptions used to evaluate a security and its underlying collateral, and it would also have to document all subsequent changes in its assumptions.

In this proposal, we specifically seek comment on several areas related to stress testing. Should FCA retain a standardized stress-testing option for institutions that do not wish to or do not have the capability of defining their own stress tests? Given that the Dodd-Frank Act requires us to eliminate credit ratings as a criterion for the eligibility of investments, would allowing System institutions to develop their own standards result in a variety of investment portfolios that exhibit substantially different risk profiles? Could this result in an inappropriate amount of risk in some investment portfolios? Also, should our regulations require stress-testing on all investments at the time of purchase? If not, on which investments should we require stress-testing, and why? Should institutions be required to stress test their individual investments and their entire investment portfolio on a quarterly basis? Why or why not?

c. Proposed § 615.5133(f)(3)—Ongoing Value Determination

We propose to redesignate existing § 615.5133(f)(2) as § 615.5133(f)(3). We propose to revise the last sentence of this provision to require an institution to evaluate the credit quality and price sensitivity of each investment in its portfolio and of its whole investment portfolio to the change in market interest rates. This change would clarify the meaning of this provision. We also propose to make other non-substantive changes to this provision.

d. Proposed § 615.5133(f)(4)—Presale Value Verification

We propose to redesignate existing § 615.5133(f)(3) as § 615.5133(f)(4) and to change the word ''security'' to ''investment.''

6. Proposed § 615.5133(g)—Reports to the Board of Directors

We propose revisions to § 615.5133(g), which specifies information that management must report to the board or a board committee each quarter.

Proposed § 615.5133(g)(1) would retain the general quarterly reporting requirements but would add to and modify them to strengthen the overall reporting requirements. Proposed § 615.5133(g)(2) would add a special reporting requirement.

Proposed § 615.5133(g)(1) would require management to report to the board of directors or a designated board committee at least quarterly on the following:

- Plans and strategies for achieving the board's objectives for the investment portfolio;
- Whether the investment portfolio effectively achieves the board's objectives;
- The current composition, quality, and liquidity profile of the investment portfolio;
- The performance of each class of investments and the entire investment portfolio, including all gains and losses that the institution incurred during the quarter on individual investments that it sold before maturity and why they were liquidated;
- Potential risk exposure to changes in market interest rates as identified through quarterly stress testing and any other factors that may affect the value of the institution's investment holdings;
- How investments affect the institution's capital, earnings, and overall financial condition;
- Any deviations from the board's policies (must be specifically identified); and
- The results of the institution's quarterly stress test.

We believe that these reporting requirements are best practices and are items that boards of directors or a designated board committee must know to exercise proper governance. We also believe that the use of the investment plan discussed below would be an important tool and an effective way to report to the board on the requirements above. Presenting an investment plan and its results to the board or designated board committee would provide assurances that all required reporting takes place.

Proposed § 615.5133(g)(2) would add a special reporting requirement. It would require an institution to provide immediate notification to its board of directors or to a designated board committee if its portfolio exceeded the quarterly stress-test parameters defined in the board policy required by proposed § 615.5133(f)(2)(ii). We propose this requirement because exceeding board policy parameters could lead to serious risk exposures for the institution.

7. Investment Plan and Investment Oversight Committee

Although not a regulatory requirement, each System institution that maintains an investment portfolio should develop an investment plan and establish a formal investment oversight committee. These practices enable management to implement the investment direction provided by the institution's board. In addition, as discussed above under reporting, management's presentation of an investment plan to the board or designated board committee, along with the investment portfolio results, would provide assurances that required reporting takes place.

An institution's senior management should develop a sufficiently detailed investment plan to appropriately execute the board's approved investment strategies and achieve business plan goals of the institution. The plan should be approved by senior management or an appropriate management committee. The investment plan should help provide for effective guidelines and control over the investment portfolio. The plan should be a working document that can deal with changes in market conditions. Investment plans should describe:

- The target portfolio composition given the board's investment policy, current market conditions, and projected liquidity needs;
- The rebalancing activities needed to achieve the target portfolio; and
- The performance measures that will be used to measure portfolio performance. Such measures should include target portfolio spread given the target portfolio composition and anticipated various spreads in relation to the institution's cost of funds.

To effectively implement the investment plan, each institution should consider establishing a formal investment committee to provide additional expertise and to serve as an additional control over investment management. In the past, the asset/liability management committees, which oversee the management of investment portfolios in most System institutions, have generally provided sufficient oversight of these portfolios. However, the importance, volume, and growing complexity of System investments may warrant additional expertise in the form of a more specialized investment committee. In addition to providing additional expertise, the investment committee would also provide for separation of duties between allocation and risk strategies and the actual traders. This committee could also provide appropriate monitoring and governance as well as provide structure or formalization of many of the informal processes.

D. Section 615.5135—Management of Interest Rate Risk

Interest rate risk management is an important part of the overall financial management of a Farm Credit bank. The potentially adverse effects that interest rate risk may have on net interest income and the market value of equity is of particular importance.

We believe that strong policy direction from a Farm Credit bank's board of directors is essential to an effective interest rate risk management program. Existing § 615.5135 requires a bank's board to adopt an interest rate risk management section of an asset/liability management policy. Our proposed revisions to this rule would strengthen a bank's interest rate risk management program. The existing requirements would remain. In addition, the revisions would require the interest rate risk management section of the asset/liability management policy to establish policies and procedures for the bank to:

- Address the purpose and objectives of interest rate risk management;
- Consider the impact of investments on interest rate risk based on the results of the stress testing required under proposed § 615.5133(f)(2); [14]
- Describe actions needed to obtain its desired risk management objectives;
- Identify exception parameters and approvals needed for any exceptions to the requirements of the board's policies;
- Describe delegations of authority;
- Describe reporting requirements, including exceptions to limits contained in the board's policies; and
- Consider the nature and purpose of derivative contracts and establish counterparty risk thresholds and limits for derivatives used to manage interest rate risk.

Boards of directors set policy direction for the institution. Bank management carries out this direction and is responsible for reporting back to

[14] Existing § 615.5135 already requires Farm Credit banks to include investments in their interest rate shock analysis. Farm Credit banks may wish to review an advisory on interest rate risk management, issued by certain other agencies in January 2010, that discusses stress testing. *See, Advisory on Interest Rate Risk Management,* issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Financial Institutions Examination Council State Liaison Committee (January 6, 2010).

the board on its implementation of board direction and results. Consequently, we would expect that many of the above requirements would be carried out by management or a committee comprised of management and directors.

In addition, our proposal would require that management of each Farm Credit bank must report at least quarterly to its board of directors, or to a designated committee of the board, describing the nature and level of interest rate risk exposure. Any deviations from the board's policy on interest rate risk must be specifically identified in the report and approved by the board or a designated committee of the board.

Finally, we propose several minor technical and clarifying amendments, such as changing ''shall'' to ''must''.

E. Section 615.5136—Emergencies Impeding Normal Access of Farm Credit Banks to Capital Markets

This section provides that 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 FCA determines, after consultations with the Funding Corporation, that such an emergency exists, the FCA Board shall, in its sole discretion, adopt a resolution that increases the amount of eligible investments that banks are authorized to hold pursuant to § 615.5132, and/or modifies or waives the liquidity reserve requirement in § 615.5134.

We propose revisions to provide additional flexibility to the resolution that the FCA Board may adopt. First, in recognition that events such as the 2008 market turmoil may not allow for the deliberation contemplated by this regulation, we propose to clarify that the Funding Corporation consultation should occur only ''to the extent practicable.'' Second, the proposed rule would provide that FCA ''may'', rather than ''shall'', adopt a resolution. Third, rather than permitting the resolution to increase the authorized amount of eligible investments, the proposed rule would permit the resolution to modify the amount, qualities, and types of authorized, eligible investments. Finally, we propose to expressly permit the resolution to authorize other actions as deemed appropriate.

F. Section 615.5140—Eligible Investments

We last revised our listing of eligible investments, at § 615.5140, in 1999.[15] Those amendments expanded the list of eligible investments and relaxed or repealed certain restrictions that had previously been in the regulation. As a result, those amendments allowed System institutions to purchase and hold a broader array of high-quality and liquid investments. Those revisions reflected changes in the financial markets and helped fulfill our objective of developing a regulatory framework that could more readily accommodate innovations in financial products and analytical tools.

The recent financial crisis resulted in substantial turmoil in the financial markets. Overall, System institutions weathered this crisis better than many other regulated financial institutions. We believe this is due in part to the limited scope of authorized investments. Even so, some System institutions did experience losses on certain types of investments.

Based on this experience, we now propose amendments that would clarify which investments are eligible, eliminate certain investments, and reduce portfolio limits where appropriate. In addition, we ask questions about the most effective way to comply with section 939A of the DFA. As discussed in greater detail below, that provision requires each Federal agency to revise all regulations that refer to or require reliance on credit ratings to assess creditworthiness of an instrument to remove the reference or requirement and to substitute other appropriate creditworthiness standards.

1. Proposed Revisions to § 615.5140(a)

a. Proposed § 615.5140(a)—Introductory Paragraph

We propose revisions to the language in the introductory paragraph of § 615.5140(a). The existing language authorizes institutions to hold only the eligible investments that are listed and prohibits institutions from purchasing investments that are not listed. It also prohibits them from holding investments that were eligible when purchased but that subsequently became ineligible.

Like our existing regulation, our proposal would permit institutions to purchase only those investments that satisfy the eligibility criteria in § 615.5140. An investment that does not satisfy the eligibility criteria would not be eligible for purchase and would be subject to the divestiture requirements of proposed § 615.5143(a) if it were purchased.[16]

In a change from our existing approach, however, eligibility would be determined only at the time of purchase. An investment that satisfies the eligibility criteria at the time of purchase but that subsequently failed to satisfy the eligibility criteria would not become ineligible and would not have to be divested. Instead, it would be subject to the requirements of proposed § 615.5143(b), which would permit an institution to retain the investment subject to certain conditions.[17] As discussed below, in our discussion of our proposed amendments to § 615.5143, we believe this change would reduce regulatory burden without creating safety and soundness concerns.

In addition, existing § 615.5140(a) states that all investments must be denominated in United States dollars. We propose to relocate this language to § 615.5140(b).

b. Proposed § 615.5140(a)(1) and (a)(2)—Obligations of the United States and Obligations of Government-Sponsored Agencies

Existing § 615.5140(a)(1) lists ''Obligations of the United States'' as an eligible asset class. Under that heading three items are listed: Treasuries; agency securities (except mortgage securities); and other obligations fully insured or guaranteed by the United States, its agencies, instrumentalities, and corporations. We believe this listing is confusing and does not appropriately differentiate among obligors. Although the heading reads ''Obligations of the United States'', the second and third items are intended to include debt securities and other non-mortgage obligations of GSEs such as Fannie Mae and Freddie Mac, which are not obligations of the United States.[18]

[15] *See* 64 FR 28884 (May 28, 1999).

[16] In this context, ''purchase'' would include an acquisition such as a swap of one security in exchange for another. It would not include an acquisition through a merger or consolidation of institutions. This interpretation is consistent with our interpretation of the existing rule.

[17] Investments that do not meet our eligibility criteria that are acquired through a merger or consolidation would also be subject to the requirements of § 615.5143(b).

[18] We use the term ''Obligations of the United States'' to refer to obligations that are fully and explicitly insured or guaranteed by the full faith and credit of the United States. Although the United States Government placed Fannie Mae and Freddie Mac in conservatorship in September 2008 and has taken certain actions to effectively provide protection to the holders of obligations issued and guaranteed by the GSEs, these obligations are not explicitly insured or guaranteed by the United States Government's full faith and credit.

Accordingly, we propose to split this listing into two categories. We do not intend any substantive changes with this proposed revision. We intend only to clarify the existing language.

The first listing, under § 615.5140(a)(1), would be headed ''Obligations of the United States'', and it would include only non-mortgage obligations, including but not limited to Treasuries, that are fully insured or guaranteed by a *Government agency* (which by definition means they are backed by the full faith and credit of the United States).[19] The second listing, under § 615.5140(a)(2), would be headed ''Obligations of Government-Sponsored Agencies'', and it would include debt securities and other non-mortgage obligations of GSEs, as well as of Federal agencies, such as the Tennessee Valley Authority, that issue obligations that are not explicitly insured or guaranteed by the full faith and credit of the United States.[20]

Proposed § 615.5140(a)(2) would permit institutions to purchase obligations of Government-sponsored agencies only if the obligations are senior debt securities. We believe that limiting permissible investments in this manner helps to ensure that institutions maintain only the highest quality investments in their portfolios.

c. Proposed § 615.5140(a)(3)—Municipal Securities

Existing § 615.5140(a)(2) places no investment portfolio limits for general obligation municipal securities. We propose to modify this provision (redesignated as § 615.5140(a)(3)) to impose a 15-percent investment portfolio limit on these securities. We propose this limit because we believe that a portfolio solely comprised of general obligation municipal securities would not provide sufficient liquidity in the event of a crisis in that particular market. We note that this limit is consistent with our existing revenue bond municipal securities investment portfolio limit.

[19] As discussed above, in § 615.5131 we propose to define *Government agency* as ''the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations are fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States.''

[20] As discussed above, in § 615.5131 we propose to define *Government-sponsored agency* as ''an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the United States Congress but whose obligations are not explicitly insured or guaranteed by the full faith and credit of the United States Government, including but not limited to any Government-sponsored enterprise.''

d. Proposed § 615.5140(a)(4)—International and Multilateral Development Bank Obligations

Existing § 615.5140(a)(3) places no final maturity limit and no investment portfolio limit on international and multilateral development bank obligations. In redesignated § 615.5140(a)(4), we propose imposing a 10-year maturity limit and a 15-percent investment portfolio limit, to ensure a more diversified and liquid portfolio. We believe that a portfolio containing longer term obligations or comprised of an excess of these obligations would not provide sufficient liquidity in the event of a crisis in that particular market. We note that System institutions have invested in these obligations only on a limited basis.

e. Proposed § 615.5140(a)(5)—Money Market Instruments

Existing § 615.5140(a)(4) permits institutions to invest in repurchase agreements that satisfy specified conditions. If the counterparty defaults, the regulation requires the institution to divest non-eligible securities in accordance with the divestiture requirements of § 615.5143. Under our proposal, (redesignated § 615.5140(a)(5)) as discussed above, an eligible investment could not become ineligible, and would not be required to be divested. Accordingly, we propose to delete this divestiture requirement.

f. Proposed § 615.5140(a)(6)—Mortgage Securities

Existing § 615.5140(5) requires stress testing of all mortgage securities. As discussed above, proposed § 615.5133(f) would require stress testing on all investments held in an institution's portfolio. Accordingly, we propose to delete the specific stress-testing requirement for mortgage securities (which would be listed in redesignated § 615.5140(a)(6)).

The first category listed in existing § 615.5140(a)(5) is mortgage securities that are issued or guaranteed by the United States. In redesignated § 615.5140(a)(6), we propose to revise this category to refer to mortgage securities that are fully guaranteed or fully insured by a Government agency.[21] This change makes clear that this category includes only mortgage securities that are fully backed by the full faith and credit of the United States. If the United States Government issues a mortgage security that is not fully guaranteed or fully insured by the full faith and credit of the United States Government, it is not eligible under this category.

[21] As discussed above, in § 615.5131 we propose to define *Government agency* as ''the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations are fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States.''

The second category listed in existing § 615.5140(a)(5) is Fannie Mae and Freddie Mac mortgage securities. As discussed above, the United States Government placed these two housing GSEs in conservatorship in September 2008, and their future remains uncertain. As long as they remain in conservatorship, we believe the existing 50-percent investment portfolio limit is appropriate. Accordingly, we propose no changes to this category (which would be included in redesignated § 615.5140(a)(6)) at this time. Depending on what happens to these GSEs in the future, a portfolio limit reduction or other restriction may become warranted. We invite your comments regarding revisions you believe we should make to this category of investments.

The third category listed in existing § 615.5140(a)(5) is non-Agency securities that comply with 15 U.S.C. 77d(5) or 15 U.S.C. 78c(a)(41). For the purpose of clarification, in redesignated § 615.5140(a)(6), we propose to replace the term ''non-Agency'' with a reference to securities that are not fully insured or guaranteed by a Government agency, Fannie Mae, or Freddie Mac. We intend no substantive change with this clarification. Furthermore, in this preamble we continue the shorthand reference to these securities as non-Agency mortgage securities.

Under proposed § 615.5140(a)(6), a position in a non-Agency mortgage security would be eligible only if it is the senior-most position at the time of purchase. The FCA considers a position in a non-Agency mortgage security to be the senior-most position only if it currently meets both of the following criteria:

- No other remaining position in the securitization has priority in liquidation. Remaining positions that are the last to experience losses in the event of default and which share those losses pro rata meet this criterion.
- No other remaining position in the securitization has a higher priority claim to any contractual cash flows. Remaining positions that have the first priority claim to contractual cash flows (including planned amortization classes), as well as those that share on a pro rata basis a first priority claim to cash flows meet this criterion.

Institutions should be aware that the tranche that is the senior-most position at the time they are considering purchase is not necessarily the same tranche that was in the senior-most position at the time of issue. Institutions should also be careful not to be misled by the labeling of tranches as ''super senior'' or ''senior'' in a prospectus (or on market reporting services). Institutions may purchase non-Agency mortgage-backed securities (MBS) only if the securities satisfy the above two criteria at the time of purchase. Any security that would not satisfy the eligibility criteria after purchase because of the terms of the contract or because of structural issues would not be eligible.

In addition, we propose to reduce the investment portfolio limit for non-Agency mortgage securities from 15 to 10 percent to reduce the exposure in MBS that are not fully insured or guaranteed by the United States. We believe reducing exposure in this area of uninsured securities would result in a more diversified and liquid portfolio.

We note that the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, United States Securities and Exchange Commission, Federal Housing Finance Agency, and Department of Housing and Urban Development (collectively, the other agencies) have proposed a rule to implement the credit risk retention requirements of section 15G of the Securities and Exchange Act of 1934, as added by section 941 of the DFA.[22] If this proposed rule of the other agencies is finalized, it could change the risk characteristics of investments that System institutions invest in. Consequently, FCA may consider further revisions to portfolio limits at that time.[23]

Finally, we propose to eliminate commercial mortgage-backed securities, which are included in existing § 615.5140(a)(5), from the list of eligible investments. We believe that these securities pose undue risk due to the nature of the collateral underlying these securities.

g. Proposed § 615.5140(a)(7)—Asset-Backed Securities

Existing § 615.5140(a)(6) authorizes investments in asset-backed securities with a 20-percent investment portfolio limit. In redesignated § 615.5140(a)(7), we propose to reduce the investment portfolio limit from 20 to 15 percent, with no more than 5 percent of the investment portfolio in any one type of collateral. We propose this change because we believe that certain asset-backed securities, such as home equity loans and manufactured housing loans, present appreciable, albeit manageable, risk. We believe this reduction will help limit the exposure of System institutions in investments such as manufactured housing and home equity loans that experienced considerable stress during the financial crisis.

h. Proposed § 615.5140(a)(8)—Corporate Debt Securities

Existing § 615.5140(a)(7) authorizes investments in corporate debt securities, subject to a 20-percent investment portfolio limit. The provision also prohibits investments in securities that are convertible to equity securities.

In redesignated § 615.5140(a)(8), we propose to add a requirement that the securities must be senior debt securities to be eligible for purchase. We would leave the portfolio limit the same, but we would create additional diversification by requiring that no more than 10 percent of the investment portfolio be in any one of the 10 industry sectors as defined by the Global Industry Classification Standard (GICS).[24]

i. Proposed § 615.5140(a)(9)—Diversified Investment Funds

We propose to clarify our expectations for diversified investment funds contained in our existing § 615.5140(a)(8). We believe the term ''diversified investment funds'' could include closed-end funds, which are typically exchange-traded. We propose to add language stating that only open-end funds are eligible, in order to reduce the possibility that investments are purchased for potentially speculative purposes.

In addition, the existing rule imposes no investment portfolio limitation, as long as shares in each investment company comprise 10 percent or less of an institution's portfolio. Our proposal would impose a 50-percent total investment portfolio limit, with no more than 10 percent in any single fund. We believe this proposal would provide for more appropriate diversification across an institution's investment portfolio.

2. Dodd-Frank Act Compliance

In July 2010, to strengthen regulation of the financial industry in the wake of the financial crisis that unfolded in 2007 and 2008, the President signed into law the Dodd-Frank Act. Section 939A of the DFA requires the following:

- Each Federal agency must review (i) all of its regulations that require the use of an assessment of the creditworthiness of a security or money market instrument, and (ii) any references to or requirements in its regulations regarding credit ratings.
- Each Federal agency must modify its regulations to remove any reference to or requirement of reliance on credit ratings and to substitute in the regulations such standards of creditworthiness as the agency determines is appropriate. In making this determination, the agency must seek to establish, to the extent feasible, uniform standards of creditworthiness.

We have completed our review of FCA regulations that impose creditworthiness requirements or that refer to or require the use of credit ratings. Existing § 615.5140(a) is one such regulation; it requires minimum NRSRO[25] credit ratings for many categories of investments—including municipal securities, certain money market instruments, non-Agency mortgage securities, asset-backed securities, and corporate debt securities—in order for them to be eligible.

There are a number of different ways to assess creditworthiness, and we are considering which approach or combination of approaches would be most appropriate in this context. It may well be that we would want to propose several of these approaches in concert with one another. In the discussion below, we explore various approaches that could be considered for assessing creditworthiness as a determinant of eligibility for purposes of § 615.5140(a).[26]

First, our regulation could specify financial measurements, benchmark indexes, and other measurable criteria against which institutions could evaluate the creditworthiness of their investments. The regulation could

[22] *See* 76 FR 24090 (April 29, 2011).

[23] Future revisions could include changes to the portfolio limits for asset-backed securities contained in proposed § 615.5140(a)(7), as well as to changes to the portfolio limits for non-Agency mortgage securities contained in proposed § 615.5140(a)(6).

[24] GICS was developed by Morgan Stanley Capital International and Standards and Poor's. The GICS is an industry analysis framework for investment research portfolio management and asset allocation. The GICS structure consists of 10 sectors, 24 industry groups, 68 industries, and 154 sub-industries. More information can be found at *http://www.mscibarra.com/products/indices/gics.*

[25] Nationally recognized statistical rating organization.

[26] In addition, existing § 615.5140(b), which we propose to redesignate as § 615.5140(c), provides that whenever the obligor or issuer of an eligible investment is located outside the United States, the host country must maintain the highest sovereign rating for political and economic stability by an NRSRO. The DFA requires us to replace that NRSRO standard with an appropriate substitute. The following discussion also applies to that provision.

specify factors and standards of criteria for various classes of investments. Institutions would need to ensure that these criteria were met in order for an investment to be eligible or suitable at the time of purchase. Some of the factors that could be considered as criteria to ensure a high quality, highly liquid investment portfolio include:

• Credit spreads (*i.e.*, whether it is possible to demonstrate that a position in certain investments is subject to a minimal amount of credit risk based on the spread between the security's yield and the yield of Treasury or other securities, or based on credit default swap spreads that reference the security);

• Default statistics (*i.e.*, whether providers of credit information relating to securities express a view that specific securities have a probability of default consistent with other securities with a minimal amount of credit risk);

• Inclusion on an index (*i.e.*, whether a security, or issuer of the security, is commonly included as a component of a recognized index of instruments that are subject to a minimal amount of credit risk);

• Priorities and enhancements (*i.e.*, the extent to which a security includes credit enhancement features, along with an evaluation of the relative strength of the enhancements, such as overcollateralization and reserve accounts, or has priority under applicable bankruptcy or creditors' rights provisions);

• Price, yield and/or volume (*i.e.*, whether the price and yield of a security or a credit default swap that references the security are consistent with other securities that are subject to a minimal amount of credit risk and whether the price resulted from active trading); and

• Asset class-specific factors (*e.g.*, in the case of structured finance products, the risk characteristics of the specific underlying collateral).

Is this approach one that FCA should consider, and are there other criteria that should be included? Should the creditworthiness standard include specific standards for probability and loss given default? If so, why, and where could the Agency source such data to derive such probabilities? Also, should this vary by asset class and/or type of investment? Finally, would it be appropriate to combine this approach with one or more of the other approaches, and if so, which ones, and why?

Second, our regulation could require System institutions to develop their own internal assessment process for evaluating the creditworthiness of investments. We believe that the level of due diligence needed to validate such a system could require significant effort on the part of System institutions. In addition, the internal evaluation system would need to be validated and might need to be frequently recalibrated based on changes in the marketplace. Institutions would need to be able to demonstrate to FCA that the probability of default characteristics and loss given default characteristics are verifiable and accurate. Any internal assessment would also have to consider an investment's marketability, liquidity, and pricing risk for determining eligibility and suitability.

The System has developed a standardized 14-point risk rating summary that institutions use to classify their loan portfolios. Similar criteria could possibly be used in the assessment of whether an investment is eligible or suitable for the portfolio. However, additional validation would likely be needed to ensure appropriate recognition of the critical factors present in investments.

Is this second approach one that we should consider? Do System institutions have the capability of validating an internal assessment system for investments, and is it appropriate to allow institutions to develop their own internal model for assessing creditworthiness of investments? If so, what standards of creditworthiness should be included, and why? If we consider an internal model approach, what would be the criteria for eligibility, and why? Also, should an assessment of creditworthiness link directly to a bank's loan rating system and if so, how should differences in classifications pertaining to eligibility be handled? Finally, would it be appropriate to combine this approach with one or more of the other approaches and, if so, which ones, and why?

Third, FCA could develop regulations that would require institutions to use third party assessments to assess creditworthiness. Organizations other than NRSROs may have the capability to evaluate creditworthiness, and this evaluation could be considered in an institution's eligibility and suitability assessment. We also believe that the DFA does not prohibit System institutions from looking to the NRSROs as a tool for assessing creditworthiness. Institutions that do so, however, should evaluate the quality of third party assessments by considering whether issuers or investors pay the rating fees. Moreover, as we have seen in the recent crisis, reliance on third party analysis can be problematic and cannot be used in isolation. Accordingly, if we were to require this approach, it would likely be in concert with one or more of the other approaches.

Is this third approach one that we should consider? What reliable third party sources exist? Would it be appropriate to combine this approach with one or more of the other approaches and if so, which ones, and why?

Fourth, FCA could develop a set of clearly defined criteria from which we would create a scale that ranks creditworthiness. We would then require System institutions to conduct due diligence to ensure that an investment they purchase actually complies with the criteria. The criteria could be as follows:

Highest Standard—Obligations must be of the highest quality with minimal credit risk. Issuers must have an extremely strong capacity to meet its long-term financial obligations and a superior ability to repay short-term debt obligations.

High Standard—Obligations must be of a high quality and subject to very low credit risk. Issuers must have a very strong capacity to meet its long-term financial obligations and a strong ability to repay short-term debt obligations.

We recognize that these standards may be viewed differently by different System institutions. This approach would require significant due diligence and controls in place to ensure consistency. It could also result in one institution determining an investment is eligible while another may determine an investment is not eligible at the time of purchase.

Is this fourth approach one that we should consider and, if so, what definitional criteria should be used? Would it be appropriate to combine this approach with one or more of the other approaches and, if so, which ones, and why?

In considering the requirements of the Dodd-Frank Act and the reasons for its enactment, do the above approaches allow for too much subjectivity and inconsistency? Alternatively, is there an approach that would allow for objective criteria that would lead to consistency in assessing eligibility? We are also considering how difficult and costly in practice any of the potential approaches or combination of approaches would be. In addition, we are considering whether there are other approaches to assessing creditworthiness that would be more appropriate. Finally, as a related matter, we are interested in what specific methods and standards an institution should be required to apply to appropriately assess the political and economic stability of a foreign country that hosts the obligor or issuer of an eligible investment.

3. Changes to Remainder of § 615.5140

As discussed above, we propose to relocate to § 615.5140(b) the requirement, currently contained in the introductory paragraph of § 615.5140(a), that all investments must be denominated in United States dollars.

We propose to delete our existing § 615.5140(c), which requires that all eligible investments, except money market instruments, must be marketable. We expect that in an upcoming rulemaking, we will propose to include that requirement in § 615.5134.

We propose to reduce to 15 percent the 20-percent obligor limit contained in our existing § 615.5140(d)(1). We believe this reduction is appropriate because it helps to ensure diversification among obligors.

We also propose to clarify, consistent with the amendments to terminology that we propose in § 615.5140(a) and (b), that the obligor limit does not apply to obligations that are issued or guaranteed as to interest and principal by Government agencies or Government-sponsored agencies (rather than to obligations that are issued or guaranteed as to interest and principal by the United States, its agencies, instrumentalities, or corporations). We intend no substantive change with this clarification.

Obligations that are not fully insured or fully guaranteed by a Government agency or Government-sponsored agency present relatively greater risk than do obligations that are so insured or guaranteed. We also believe that money market instruments generally present more limited risk. We seek comment on whether an overall combined portfolio limit—including all obligations except for money market instruments and those fully insured or fully guaranteed by Government agencies and Government-sponsored agencies—would be appropriate. Should we implement such a limit and, if so, what should the limit be? In addition, in light of the concentration that can occur in the housing sector, should we consider implementing a housing sector limit? Why or why not?

G. Section 615.5141—Stress Tests for Mortgage Securities

Because we propose to relocate our stress-testing requirements to § 615.5133(f), we also propose to remove this stand-alone, stress-testing section from our regulations.

H. Section 615.5142—Association Investments

Section 615.5142 implements sections 2.2(10) and 2.12(18) of the Act, which require each funding bank to supervise and approve the investment activities of its affiliated associations. Section 615.5142 authorizes an association to hold eligible investments, listed in § 615.5140, with the approval of its funding bank, for the purposes of reducing interest rate risk and managing surplus short-term funds. Each bank must review annually the investment portfolio of every association that it funds.

Although funding banks are required to supervise and approve the investment activities of an association, when we adopted this regulation in 1999, we emphasized that bank oversight does not absolve an association's board and managers of their fiduciary duties to manage investments in a safe and sound manner. We stated that the fiduciary responsibilities of association boards obligate them to develop appropriate investment management policies and practices to manage the risks associated with investment activities. We also stated that each association's investment managers must fully understand the risks of its investments and make independent and objective evaluations of investments prior to purchase.[27]

In addition, we emphasized that each association with a nonagricultural investment portfolio is required to develop an investment policy that is based on its unique characteristics and that is commensurate with the nature of its investment activities and portfolio. An association must comply with all the requirements in § 615.5133 if the level or type of its investments could expose its capital to material loss.[28]

This guidance is still valid today. However, we believe additional clarification and a regulatory revision are appropriate.

As a point of clarification, although § 615.5142 permits association investments for the purpose of, in pertinent part, reducing interest rate risk, the interest rate risk of most associations is managed by their respective funding banks. Accordingly, interest rate risk at the association level is generally minimized although not completely eliminated. The use of investments for reducing interest rate risk should be commensurate with the actual interest rate risk exposure of the association. Furthermore, associations that engage in investment activities must ensure that their investments do not increase interest rate risk.

Section 615.5142 also permits associations to invest surplus short-term funds. We are concerned that an association could draw on its line of credit with its funding bank to obtain ''surplus'' short-term funds that it would invest in an investment with a longer term or repricing characteristics than the term and repricing characteristics of the funding. Funding a longer term investment with short-term funds creates the potential for interest rate risk. Because of this potential risk, associations must carefully manage their investments of surplus short-term funds.

Accordingly, we propose to add paragraph (b) to § 615.5142. Paragraph (b) would require that before an association purchases an eligible investment for the purpose of managing surplus short-term funds, it must ensure that the investment's repricing and maturity characteristics match the characteristics of the surplus short-term funds to be invested.

In addition, although we do not propose this as a requirement at this time, we believe that in order for an investment to be made for the purpose of managing surplus ''short-term'' funds, the funds generally should be invested in instruments that are ''overnight'' or that have maturities of 30 days or less. We seek comment on whether we should define surplus short-term funds and if so how. Further, is our belief that surplus short-term funds should only be invested in overnight investments or in investments with maturities of 30 days or less appropriate? Lastly, is our proposed limitation on the permissible characteristics of investments purchased for the purpose of managing surplus short-term funds appropriate for associations, or does it unreasonably restrict an association's ability to properly hold and manage investments?

I. Section 615.5143—Management of Ineligible and Unsuitable Investments

Existing § 615.5143 requires an institution to dispose of an investment that is ineligible (under the § 615.5140 criteria) within 6 months unless we approve, in writing, a plan that authorizes the institution to divest the instrument over a longer period of time. An acceptable divestiture plan must require the institution to dispose of the ineligible investment as quickly as possible without substantial financial loss. Until the institution actually disposes of the ineligible investment, the institution's investment portfolio managers must report on specified

[27] *See* 64 FR 28885–28886 (May 28, 1999).

[28] *Id.*

matters to the board of directors at least quarterly.

During the financial crisis of the past few years, we have received numerous divestiture plans from System institutions seeking our permission to continue to retain ineligible investments. Nearly all of these plans have involved investments that have become ineligible due to credit ratings downgrades.[29] Typically, the analyses in the divestiture plans have indicated that holding the instruments until maturity or until market conditions improve would minimize losses, compared with incurring a substantial loss with a sale in the then-current market. Moreover, the investments have not materially affected the financial capacity of the institution. Accordingly, we have approved all investment plans that we have received in at least the last 5 years.

The automatic 6-month divestiture requirement, with FCA approval needed for a longer divestiture period, has proven to be inefficient and unnecessary. The existing regulation requires institutions to expend time and effort to develop a divestiture plan, requires FCA staff to expend time and effort reviewing the plan and developing a recommendation, and requires the FCA Board to expend time and effort determining whether to approve the plan.

Accordingly, to reduce the regulatory burden on System institutions and to improve efficiency, proposed § 615.5143(b) would permit an institution to retain an investment that no longer satisfies the eligibility criteria set forth in § 615.5140 (that satisfied the criteria when purchased), without the need for FCA approval, subject to specified requirements that are summarized below.

Section 615.5143(b) would also permit an institution to retain an investment that satisfies the § 615.5140 eligibility criteria but that is not suitable because it does not satisfy the risk tolerance established in the institution's board policy pursuant to § 615.5133(c), subject to the same specified requirements.

The specified requirements that would have to be satisfied in order to retain an investment that no longer satisfies the § 615.5140 eligibility criteria or that is unsuitable are as follows:

1. The institution must notify FCA promptly in writing upon determining that the investment no longer satisfies the § 615.5140 eligibility criteria or is unsuitable;
2. The investment must not be used to fund the liquidity reserve requirement in § 615.5134;
3. The institution must include the investment in the § 615.5132 investment portfolio limit;
4. The institution must include the investment as collateral under § 615.5050 and net collateral under § 615.5301(c) at the lower of cost or market value; and
5. The institution must develop a plan to reduce risk arising from the investment.

The first requirement, regarding FCA notification, is necessary so that we can evaluate whether the institution is responding appropriately to the situation. The second and fourth requirements, regarding exclusion from the liquidity reserve and inclusion in collateral and net collateral, are warranted by safety and soundness concerns. The third condition, regarding inclusion in the investment portfolio limit under § 615.5132, is simply an express statement that we find no basis to exclude these investments from that limit. And the final requirement, regarding the development of a risk reduction plan, is necessary for safety and soundness purposes.

Proposed § 615.5143(a) provides that an investment that does not satisfy the § 615.5140 eligibility criteria at the time of purchase is ineligible. Institutions must not purchase ineligible investments. An institution that purchases an ineligible investment must notify us promptly, in writing, and must divest of the investment no later than 60 calendar days after determining that the investment is ineligible unless we approve, in writing, a plan that authorizes divestiture over a longer period of time.[30]

Although it is not stated in the regulation, we clarify here that an acceptable divestiture plan must require an institution to dispose of the investment as quickly as possible without substantial financial loss. The plan must also contain sufficient analysis to support continued retention of the investment, including its impact on the institution's capital, earnings, liquidity, and collateral position. Our decision will not be based solely on financial loss.

Until the institution divests of the investment:

1. It must not be used to fund the liquidity reserve requirement in § 615.5134;

2. It must be included in the § 615.5132 investment portfolio limit; and

3. It must not be included as collateral under § 615.5050 or net collateral under § 615.5301(c).

We believe each institution should exercise sufficient due diligence to ensure it does not purchase ineligible investments. Such a purchase would indicate weaknesses in an institution's internal controls and due diligence, and the institution should expect greater examination scrutiny if this occurs. We expect such a purchase to be extremely rare.

Proposed § 615.5143(c) would require each institution to report to its board at least quarterly on the following:

1. The status and performance of each investment that is ineligible; was eligible when purchased but now does not meet the eligibility criteria; or is unsuitable because it does not fit the institution's risk tolerance;

2. The impact that the investments described above may have on the institution's capital, earnings, liquidity, and collateral position; and

3. The terms and status of any required divestiture plan or risk reduction plan.

This reporting allows the institution's board to exercise appropriate oversight over investments that are ineligible, unsuitable, or otherwise problematic.

Finally, proposed § 615.5143(d) would reserve FCA's authority to require an institution to divest of any investment at any time for safety and soundness purposes. In using this authority, the FCA would consider the expected loss on the transaction (or transactions) and the impact on the institution's financial condition and performance. Because the proposed rule would not require divestiture of any investment that was eligible when purchased, FCA must reserve the authority to require divestiture of investments when necessary.

[29] As discussed elsewhere in this preamble, section 939A of the Dodd-Frank Act requires us to remove credit ratings from our eligibility criteria and to substitute other appropriate standards of creditworthiness. We are currently asking questions about how best to develop appropriate creditworthiness standards to include in our eligibility criteria in § 615.5140. Once we have revised our eligibility criteria, a credit-rating downgrade would no longer cause an investment to fail to satisfy the criteria, but an inability to meet the new creditworthiness standards would cause an investment to fail to satisfy the criteria.

[30] In this context, ''purchase'' would include an acquisition such as a swap of one ineligible security for another. It would not include an acquisition through a merger or consolidation of institutions. Investments that do not meet our eligibility criteria that are acquired through a merger or consolidation would be subject to the requirements of § 615.5143(b).

J. Section 615.5174—Farmer Mac Securities

We propose changes to § 615.5174(d), which governs stress testing of Farmer Mac securities, which Farm Credit banks, associations, and service corporations are permitted to purchase and hold for the purposes of managing credit and interest rate risk and furthering their mission to finance agriculture. Existing § 615.5174(d) requires institutions to perform stress tests on Farmer Mac securities in accordance with the requirements of § 615.5141. It also requires institutions to divest Farmer Mac securities that fail a stress test, as required by § 615.5143.

Institutions often participate existing mortgage loans to Farmer Mac in exchange for mortgage-backed securities guaranteed by Farmer Mac. These securities are, in essence, loans that have had the credit risk transferred to Farmer Mac. The loans were not subject to the stress-testing requirements applicable to investments, and it does not seem reasonable to impose those stress-testing requirements on the securities with which the loans were exchanged. Accordingly, we propose to remove the requirement that a System institution must subject Farmer Mac securities backed by loans that the institution originated to the stress testing applicable to investments.[31] If a System institution purchases a Farmer Mac security from another System institution or from outside the System, however, the security would remain subject to the stress testing applicable to investments.[32]

In addition, because other investments would no longer have to be divested if they fail a stress test, we propose to remove this requirement for Farmer Mac securities as well.

We also propose to add a definition of the term ''you'' in a new § 615.5174(e), to clarify that the regulation applies to Farm Credit banks, associations, and service corporations.

Finally, throughout § 615.5174 we propose conforming changes to references to regulations we are proposing to revise, to ensure the references continue to refer to the appropriate regulatory provisions.

[31] Institutions remain subject to the stress-testing expectations we set forth in our Informational Memorandum dated March 4, 2010. These expectations apply to all sources of risk to an institution's balance sheet, including but not limited to loans and investments.

[32] As discussed above, we propose to move the investment stress-testing requirements from § 615.5141 to § 615.5133(f).

IV. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), the FCA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, System institutions are not ''small entities'' as defined in the Regulatory Flexibility Act.

List of Subjects in 12 CFR Part 615

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

For the reasons stated in the preamble, part 615 of chapter VI, title 12 of the Code of Federal Regulations is proposed to be amended 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, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 6.20, 6.26, 8.0, 8.3, 8.4, 8.6, 8.7, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2278b, 2278b–6, 2279aa, 2279aa–3, 2279aa–4, 2279aa–6, 2279aa–7, 2279aa–8, 2279aa–10, 2279aa–12); sec. 301(a) of Pub. L. 100–233, 101 Stat. 1568, 1608; sec. 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat 1326, 1887 (15 U.S.C. 78o–7 note) (July 21, 2010).

Subpart E—Investment Management

2. Section 615.5131 is amended by:

a. Removing designations for paragraphs (a) through (l); and

b. Adding alphabetically two new definitions to read as follows:

§ 615.5131 Definitions.

* * * * *

Government agency means the United States Government or an agency, instrumentality, or corporation of the United States Government whose obligations *are* fully and explicitly insured or guaranteed as to the timely repayment of principal and interest by the full faith and credit of the United States Government.

Government-sponsored agency means an agency, instrumentality, or corporation chartered or established to serve public purposes specified by the United States Congress but whose obligations *are not* explicitly insured or guaranteed by the full faith and credit of the United States Government, including but not limited to any Government-sponsored enterprise.

* * * * *

3. Section 615.5132 is amended by adding a new sentence at the end to read as follows:

§ 615.5132 Investment purposes.

* * * Eligible investments listed under § 615.5140 that are pledged by a Farm Credit bank to meet margin requirements for derivative transactions may be excluded when calculating the amount of eligible investments held by the Farm Credit bank pursuant to this section.

4. Revise §§ 615.5133 to read as follows:

§ 615.5133 Investment management.

(a) *Responsibilities of board of directors.* Your board of directors must adopt written policies for managing your investment activities. Your board must also ensure that management complies with these policies and that appropriate internal controls are in place to prevent loss. At least annually, the board, or a designated committee of the board, must review and affirmatively validate the sufficiency of these investment policies. Any changes to the policies must be adopted by the board.

(b) *Investment policies—general requirements.* Your board's written investment policies must address the purposes and objectives of investments; risk tolerance; delegations of authority; internal controls; due diligence to determine eligibility, suitability, and the value of investments; and reporting requirements. Furthermore, your investment policies must address the means for reporting, and approvals needed for, exceptions to established policies. Investment policies must be sufficiently detailed, consistent with, and appropriate for the amounts, types, and risk characteristics of your investments. You must document in your records or board minutes any analyses used in formulating your policies or amendments to the policies.

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

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

(i) *Credit quality standards, limits on counterparty risk, and risk diversification standards that limit concentrations as follows.* Concentration limits must be based on a single or related counterparty(ies). Concentration limits must also be based on a geographical area, industries or sectors, asset classes, or obligations with similar characteristics.

(ii) *Criteria for selecting brokers, dealers, and investment bankers (collectively, securities firms).* You must buy and sell eligible investments with more than one securities firm. As part of your review of your investment policies required under paragraph (a) of this section, your board of directors, or a designated committee of the board, must review the criteria for selecting securities firms. Any changes to the criteria must be approved by the board. Also, as part of your review required under paragraph (a) of this section, the board, or a designated committee of the board, must review your existing relationships with securities firms and determine whether to continue your relationships with them. Any changes to the existing relationships with securities firms must be approved by the board.

(iii) *Collateral margin requirements on repurchase agreements.* You must regularly mark the collateral to market and ensure appropriate controls are maintained over collateral held.

(2) *Market risk.* Investment policies must set market risk limits for specific types of investments and for the investment portfolio. Your board of directors must establish market risk limits in accordance with these regulations (including, but not limited to, § 615.5135 and paragraph (f)(2) of this section) and our other policies and guidance.

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

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

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

(e) *Internal controls.* You must:

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

(2) Establish and maintain a separation of duties and supervision between personnel who execute investment transactions and personnel who post accounting entries, reconcile trade confirmations, report compliance with investment policy, and approve, revalue, and oversee investments.

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

(4) Implement an effective internal audit program to review, at least annually, your investment controls, processes, and compliance with FCA regulations and other regulatory guidance. Your internal audit program must specifically include a review of your process for ensuring all investments, at the time of purchase, are eligible and suitable for purchase under your board's investment policies.

(f) *Due diligence to determine eligibility, suitability, and value of investments.*

(1) *Eligibility and suitability for purchase.* Before you purchase an investment, you must conduct sufficient due diligence to determine whether it is eligible under § 615.5140 and suitable for purchase under your board's investment policies. You must verify the value of the investment (unless it is a new issue) with a source that is independent of the broker, dealer, counterparty or other intermediary to the transaction. Your investment policies must fully address the extent of pre-purchase analysis that management must perform for various classes of investments. You must document your assessment of eligibility and suitability, including the information used in your assessment. You may use all sources available to you, including third party sources, to assess the investment. Your assessment of each investment at the time of purchase must at a minimum include an evaluation of credit risk, liquidity risk, market risk, and interest rate risk, and an assessment of the cash flows and the underlying collateral of the investment.

(2) *Pre-purchase and quarterly stress testing.*

(i) Prior to purchasing an investment, you must stress test it, in accordance with paragraph (f)(2)(iii) of this section, as defined in your board policy. Your board must approve the purchase of any investment that exceeds the stress-test parameters defined in your board policy.

(ii) On a quarter-end basis, you must stress test your entire investment portfolio, including a stress test of each individual investment, in accordance with paragraph (f)(2)(iii) of this section, as defined in your board policy. The policy defining the stress tests must specify what actions you will take if your portfolio exceeds the quarter-end, stress-test parameters defined in the board policy, and, at a minimum must include the development of a plan to bring your portfolio back into compliance with those parameters.

(iii) Your pre-purchase and quarter-end stress tests must be defined in a board approved policy and must include defined parameters for the types of securities you purchase. The stress tests must be comprehensive and appropriate for the risk profile of your institution. At a minimum, the stress tests must be able to measure the price sensitivity of investments over different interest rate/yield curve scenarios. The methodology that you use to analyze investment securities must be appropriate for the complexity, structure, and cash flows of the investments in your portfolio. The stress tests must enable you to determine at the time of purchase and each subsequent quarter that your investment securities, either individually or on a portfolio-wide basis, do not expose your capital, earnings, or liquidity to excessive risks. Your stress tests must enable you to evaluate the overall risk in the investment portfolio compared to your defined board policy limits. You must rely to the maximum extent practicable on verifiable information to support all your assumptions, including prepayment and interest rate volatility assumptions, when you apply your stress tests. You must document the basis for all assumptions that you use to evaluate the security and its underlying collateral. You must also document all subsequent changes in your assumptions.

(3) *Ongoing value determination.* At least monthly, you must determine the fair market value of each investment in your portfolio and the fair market value of your whole investment portfolio. In doing so you must also evaluate the credit quality and price sensitivity to the change in market interest rates of each investment in your portfolio and your whole investment portfolio.

(4) *Presale value verification.* Before you sell an investment, you must verify its value with a source that is

independent of the broker, dealer, counterparty, or other intermediary to the transaction.

(g) *Reports to the board of directors.*

(1) *Quarterly.* At least quarterly, your management must report on the following to your board of directors or a designated board committee:

(i) Plans and strategies for achieving the board's objectives for the investment portfolio;

(ii) Whether the investment portfolio effectively achieves the board's objectives;

(iii) The current composition, quality, and liquidity profile of the investment portfolio;

(iv) The performance of each class of investments and the entire investment portfolio, including all gains and losses that you incurred during the quarter on individual investments that you sold before maturity and why they were liquidated;

(v) Potential risk exposure to changes in market interest rates as identified through quarterly stress testing and any other factors that may affect the value of your investment holdings;

(vi) How investments affect your capital, earnings, and overall financial condition;

(vii) Any deviations from the board's policies (must be specifically identified); and

(viii) The results of your quarterly stress test.

(2) *Special.* You must provide immediate notification to your board of directors or to a designated board committee if your portfolio exceeds the quarterly stress test parameters defined in the board policy required by paragraph (f)(2)(ii) of this section.

5. Revise §§ 615.5135, 615.5136 and 615.5140 to read as follows:

§ 615.5135 Management of interest rate risk.

(a) The board of directors of each Farm Credit Bank, bank for cooperatives, and agricultural credit bank must develop and implement an interest rate risk management program as set forth in subpart G of this part.

(b) The board of directors of each Farm Credit Bank, bank for cooperatives, and agricultural credit bank must adopt an interest rate risk management section of an asset/liability management policy that 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 must establish policies and procedures for the bank to:

(1) Address the purpose and objectives of interest rate risk management;

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

(3) 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 and by considering the impact of investments on interest rate risk based on the results of the stress testing required under § 615.5133(f)(2);

(4) Describe, explore, and implement actions needed to obtain its desired risk management objectives;

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

(6) Evaluate and document, at least quarterly, whether these investments have actually met the objectives stated under paragraph (b)(5) of this section;

(7) Identify exception parameters and approvals needed for any exceptions to the requirements of the board's policies;

(8) Describe delegations of authority;

(9) Describe reporting requirements, including exceptions to limits contained in the board's policies;

(10) Consider the nature and purpose of derivative contracts and establish counterparty risk thresholds and limits for derivatives used to manage interest rate risk.

(c) At least quarterly, management of each Farm Credit Bank, bank for cooperatives, or agricultural credit bank must report to its board of directors, or a designated committee of the board, describing the nature and level of interest rate risk exposure. Any deviations from the board's policy on interest rate risk must be specifically identified in the report and approved by the board.

§ 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 consultation with the Federal Farm Credit Banks Funding Corporation to the extent practicable, that such an emergency exists, the Farm Credit Administration Board may, in its sole discretion, adopt a resolution that:

(a) Modifies the amount, qualities, and types 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;

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

(c) Authorizes other actions as deemed appropriate.

§ 615.5140 Eligible investments.

(a) You may purchase only the investments that satisfy the eligibility criteria in this section. An investment that does not satisfy the eligibility criteria at the time of purchase is not eligible for purchase and is subject to the requirements of § 615.5143(a) if purchased. An investment that satisfies the eligibility criteria at the time of purchase but subsequently fails to satisfy the eligibility criteria is subject to the requirements of § 615.5143(b).

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Investment Eligibility Criteria Table

Asset Class	Final Maturity Limit	NRSRO Credit Rating	Other Requirements	Investment Portfolio Limit
(1) Obligations of the United States Obligations (except mortgage securities) fully insured or guaranteed by a Government agency	None	NA	None	None
(2) Obligations of Government-sponsored agencies Government-sponsored agency securities (except mortgage securities) Other obligations (except mortgage securities) fully insured or fully guaranteed by Government-sponsored agencies	None	NA	Senior debt securities only	None
(3) Municipal Securities				
• General obligations	10 years	One of the highest two	None	15 percent
• Revenue bonds	5 years	Highest	At the time of purchase, you must document that the issue is actively traded in an established secondary market	15 percent
(4) International and Multilateral Development Bank Obligations	10 years	None	The United States must be a voting shareholder	15 percent
(5) Money Market Instruments				
• Federal funds	1 day or continuously callable up to 100 days	One of the two highest short-term	None	None
• Negotiable certificates of deposit	1 year		None	None
• Bankers acceptances	None		Issued by a depository institution	None
• Commercial paper	270 days	Highest short-term		None

• Non-callable Term Federal funds and Eurodollar time deposits	100 days		None	20 percent
• Master notes	270 days			20 percent
• Repurchase agreements collateralized by eligible investments or marketable securities rated in the highest credit rating category by an NRSRO	100 days	NA		None
(6) Mortgage Securities				
• Fully insured or guaranteed by a Government agency	None	NA		None
• Fannie Mae or Freddie Mac mortgage securities	None	NA		50 percent
• Securities that are not fully insured or fully guaranteed by a Government agency, Fannie Mae, or Freddie Mac and that comply with 15 U.S.C. 77d(5) or 15 U.S.C. 78c(a)(41)	None	Highest	Senior-most position only	10 percent
(7) Asset-Backed Securities secured by: Credit card receivables Automobile loans Home equity loans Wholesale automobile dealer loans Student loans Equipment loans Manufactured housing loans	None	Highest	5-year WAL for fixed rate or floating rate ABS at their contractual interest rate caps 7-year WAL for floating rate ABS that remain below their contractual interest rate cap	15 percent in total and no more than 5 percent of any single collateral type

(8) Corporate Debt Securities	5 years	One of the two highest	Senior debt securities only Cannot be convertible to equity securities	20 percent in total, and no more than 10 percent in any one of the 10 industry sectors as defined by the Global Industry Classification Standard (GICS)
(9) Diversified Investment Funds Shares of an investment company registered under section 8 of the Investment Company Act of 1940	NA	NA	Open-end funds only The portfolio of the investment company must consist solely of eligible investments authorized by §§ 615.5140 and 615.5174. The investment company's risk and return objectives and use of derivatives must be consistent with FCA guidance and your investment policies.	50 percent in total. No more than 10 percent in any single fund; otherwise counts towards limit for each type of investment.

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(b) *Denomination.* All investments must be denominated in United States dollars.

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

(d) *Obligor limits.*

(1) *General.* You may not invest more than 15 percent of your total capital in eligible investments issued by any single institution, issuer, or obligor. This obligor limit does not apply to obligations, including mortgage securities, that are issued or guaranteed as to interest and principal by Government agencies or Government-sponsored agencies.

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

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

§ 615.5141 [Removed]

6. Section 615.5141 is removed.

7. Section 615.5142 is amended by:

a. Adding the designation (a) to the existing paragraph; and

b. Adding a new paragraph (b) to read as follows:

§ 615.5142 Association investments.

(a) * * *

(b) Before an association purchases an eligible investment for the purpose of managing surplus short-term funds, it must ensure that the investment's repricing and maturity characteristics match the characteristics of the surplus short-term funds to be invested.

8. Section 615.5143 is revised to read as follows:

§ 615.5143 Management of ineligible and unsuitable investments.

(a) *Investments ineligible when purchased.* Investments that do not satisfy the eligibility criteria set forth in § 615.5140 at the time of purchase are ineligible. You may not purchase ineligible investments. If you determine that you have purchased an ineligible investment, you must notify us promptly in writing after such determination. You must divest of the investment no later than 60 calendar days after you determine that the investment is ineligible unless we approve, in writing, a plan that authorizes you to divest the investment over a longer period of time. Until you divest of the investment:

(1) It must not be used to fund the liquidity reserve necessary to meet the liquidity reserve requirement in § 615.5134;

(2) It must be included in the § 615.5132 investment portfolio limit; and

(3) It must not be included as collateral under § 615.5050 or net collateral under § 615.5301(c).

(b) *Investments that no longer satisfy eligibility criteria or are unsuitable.* If an investment (that satisfied the eligibility criteria set forth in § 615.5140 when purchased) no longer satisfies the eligibility criteria, or if an investment is not suitable because it does not fit the risk tolerance established in your board policy pursuant to § 615.5133(c), you may continue to hold it, subject to the following requirements:

(1) You must notify FCA promptly in writing upon your determination that the investment no longer satisfies the eligibility criteria contained in § 615.5140 or is not suitable;

(2) You must not use the investment to fund the liquidity reserve necessary to meet the liquidity reserve requirement in § 615.5134;

(3) You must include the investment in the § 615.5132 investment portfolio limit;

(4) You must include the investment as collateral under § 615.5050 and net collateral under § 615.5301(c) at the lower of cost or market value; and

(5) You must develop a plan to reduce the investment's risk to you.

(c) *Board reporting requirements.* You must report to your board at least quarterly on the following:

(1) The status and performance of each investment described in paragraphs (a) and (b) of this section.

(2) The impact that any investments described in paragraphs (a) and (b) of this section may have on your capital, earnings, liquidity, and collateral position; and

(3) The terms and status of any required divestiture plan or risk reduction plan.

(d) *Reservation of authority.* FCA retains the authority to require you to divest of any investment at any time for safety and soundness reasons. The timeframe set by FCA will consider the expected loss on the transaction (or transactions) and the impact on your financial condition and performance.

Subpart F—Property, Transfers of Capital, and Other Investments

9. Section 615.5174 is amended by:

a. Removing the reference "§ 615.5131(f)" and adding in its place, the reference "§ 615.5131" in paragraph (a); and

b. Revising paragraph (d); and

c. Adding a new paragraph (e) to read as follows:

§ 615.5174 Farmer Mac securities.

* * * * *

(d) *Stress Test.* You must perform stress tests, in accordance with § 615.5133(f)(2), on mortgage securities, issued or guaranteed by Farmer Mac, that are backed by loans that you did not originate.

(e) *You.* Means a Farm Credit bank, association, or service corporation.

Dated: August 12, 2011.

Dale L. Aultman,

Secretary, Farm Credit Administration Board.

[FR Doc. 2011–20965 Filed 8–17–11; 8:45 am]

BILLING CODE 6705–01–P

FEDERAL TRADE COMMISSION

16 CFR Part 424

Retail Food Store Advertising and Marketing Practices Rule

AGENCY: Federal Trade Commission ("FTC" or "Commission").

ACTION: Advance notice of proposed rulemaking; request for public comment.

SUMMARY: As part of the Commission's systematic review of all current FTC rules and guides, the Commission requests public comment on the overall costs, benefits, necessity, and regulatory and economic impact of the FTC's rule for "Retail Food Store Advertising and Marketing Practices" ("Unavailability Rule" or "Rule").

DATES: Comments must be received on or before October 19, 2011.

ADDRESSES: Interested parties may file a comment online or on paper, by following the instructions in the Request for Comment part of the **SUPPLEMENTARY INFORMATION** section below. Write "16 CFR Part 424—Retail Food Store Advertising Rule, Project No. P104203" on your comment, and file your comment online at *https://ftcpublic.commentworks.com/ftc/unavailabilityruleanpr,* by following the instructions on the web-based form. If you prefer to file your comment on paper, mail or deliver your comment to the following address: Federal Trade Commission, Office of the Secretary, Room H–113 (Annex N), 600 Pennsylvania Avenue, NW., Washington, DC 20580.

FOR FURTHER INFORMATION CONTACT: Jock Chung, (202) 326–2984, Attorney, Division of Enforcement, Bureau of Consumer Protection, Federal Trade Commission, 600 Pennsylvania Avenue, NW., Washington, DC 20580.

SUPPLEMENTARY INFORMATION:

I. Background

The Unavailability Rule states that it is an unfair or deceptive act or practice for "retail food stores" to advertise "food, grocery products or other merchandise" at a stated price if those stores do not have the advertised products in stock and readily available to consumers during the effective period of the advertisement. The original Rule, promulgated in 1971,[1] permitted food retailers to defend against a charge of failure to have items available by maintaining records showing that the advertised items were timely ordered and delivered in quantities sufficient to meet reasonably anticipated demand.[2]

In 1989, after a comment period and public hearings, the Commission concluded that the costs of complying with the original Rule exceeded the benefits to consumers and amended the Rule.[3] The Rule now provides that even if stores do not have the advertised products in stock and readily available during the effective period of their advertisement, they comply with the Rule if "the advertisement clearly and adequately discloses that supplies of the advertised products are limited or the advertised products are available only at some outlets."[4] In addition, the amendment provides that it would not be a rule violation if: (1) The store ordered the advertised products in adequate time for delivery in quantities

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[1] *Federal Trade Commission: Retail Food Store Advertising and Marketing Practices: Statement of Basis and Purpose: The Rule,* 36 FR 8777 (May 13, 1971). The Rule became effective on July 12, 1971.

[2] *Id.* at 8781.

[3] *Federal Trade Commission: Amendment to Trade Regulation Rule Concerning Retail Food Store Advertising and Marketing Practices,* 54 FR 35456 (Aug. 28, 1989).

[4] *Id.* at 35467.