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declines in net income or in the market value of capital shall comply with the requirements of §§ 615.5180 and 615.5181. The interest rate risk management program required under § 615.5181 shall be commensurate with the level of interest rate risk of the institution.

Subpart H—Capital Adequacy

SOURCE: 53 FR 39247, Oct. 6, 1988, unless otherwise noted.

§ 615.5200 Capital planning.

(a) The Board of Directors of each Farm Credit System institution shall determine the amount of total capital, core surplus, total surplus, and unallocated surplus needed to assure the institution's continued financial viability and to provide for growth necessary to meet the needs of its borrowers. The minimum capital standards specified in this part are not meant to be adopted as the optimal capital level in the institution's capital adequacy plan. Rather, the standards are intended to serve as minimum levels of capital that each institution must maintain to protect against the credit and other general risks inherent in its operations.

(b) Each Board of Directors shall establish, adopt, and maintain a formal written capital adequacy plan as a part of the financial plan required by § 618.8440 of this chapter. The plan shall include the capital targets that are necessary to achieve the institution's capital adequacy goals as well as the minimum permanent capital and surplus standards. The plan shall address any projected dividends, patronage distribution, equity requirements, or other action that may decrease the institution's capital or the components thereof for which minimum amounts are required by this part. The plan shall set forth the circumstances in which retirements or revolvments of stock or equities may occur. If the plan provides for retirement or revolvment of equities included in core surplus, in connection with a loan default or the death of a former borrower, the plan must require the institution to make a prior determination that such retirement or revolvment is in the best interest of the institution, and also re-

quire the institution to charge off an amount of the indebtedness on the loan equal to the amount of the equities that are retired or canceled. In addition to factors that must be considered in meeting the minimum standards, the board of directors shall also consider at least the following factors in developing the capital adequacy plan:

- (1) Capability of management and the board of directors;
- (2) Quality of operating policies, procedures, and internal controls;
- (3) Quality and quantity of earnings;
- (4) Asset quality and the adequacy of the allowance for losses to absorb potential loss within the loan and lease portfolios;
- (5) Sufficiency of liquid funds;
- (6) Needs of an institution's customer base; and
- (7) Any other risk-oriented activities, such as funding and interest rate risks, potential obligations under joint and several liability, contingent and off-balance-sheet liabilities or other conditions warranting additional capital.

[53 FR 39247, Oct. 6, 1988, as amended at 62 FR 4446, Jan. 30, 1997; 71 FR 5763, Feb. 2, 2006]

§ 615.5201 Definitions.

For the purpose of this subpart, the following definitions apply:

Allocated investment means earnings allocated but not paid in cash by a System bank to an association or other recipient.

Bank means an institution that:

- (1) Engages in the business of banking;
- (2) Is recognized as a bank by the bank supervisory or monetary authority of the country of its organization or principal banking operations;
- (3) Receives deposits to a substantial extent in the regular course of business; and
- (4) Has the power to accept demand deposits.

Commitment means any arrangement that legally obligates an institution to:

- (1) Purchase loans or securities;
- (2) Participate in loans or leases;
- (3) Extend credit in the form of loans or leases;
- (4) Pay the obligation of another;
- (5) Provide overdraft, revolving credit, or underwriting facilities; or

(6) Participate in similar transactions.

Credit conversion factor means that number by which an off-balance sheet item is multiplied to obtain a credit equivalent before placing the item in a risk-weight category.

Credit derivative means a contract that allows one party (the protection purchaser) to transfer the credit risk of an asset or off-balance sheet credit exposure to another party (the protection provider). The value of a credit derivative is dependent, at least in part, on the credit performance of a "reference asset."

Credit-enhancing interest-only strip—

(1) The term credit-enhancing interest-only strip means an on-balance sheet asset that, in form or in substance:

(i) Represents the contractual right to receive some or all of the interest due on transferred assets; and

(ii) Exposes the institution to credit risk directly or indirectly associated with the transferred assets that exceeds its pro rata claim on the assets, whether through subordination provisions or other credit enhancement techniques.

(2) FCA reserves the right to identify other cash flows or related interests as credit-enhancing interest-only strips. In determining whether a particular interest cash flow functions as a credit-enhancing interest-only strip, FCA will consider the economic substance of the transaction.

Credit-enhancing representations and warranties—

(1) The term credit-enhancing representations and warranties means representations and warranties that:

(i) Are made or assumed in connection with a transfer of assets (including loan-servicing assets), and

(ii) Obligate an institution to protect investors from losses arising from credit risk in the assets transferred or loans serviced.

(2) Credit-enhancing representations and warranties include promises to protect a party from losses resulting from the default or nonperformance of another party or from an insufficiency in the value of the collateral.

(3) Credit-enhancing representations and warranties do not include:

(i) Early-default clauses and similar warranties that permit the return of, or premium refund clauses covering, loans for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of the transfer;

(ii) Premium refund clauses covering assets guaranteed, in whole or in part, by the United States Government, a United States Government agency, or a United States Government-sponsored agency, provided the premium refund clause is for a period not to exceed 120 days from the date of transfer;

(iii) Warranties that permit the return of assets in instances of fraud, misrepresentation, or incomplete documentation; or

(iv) Clean-up calls if the agreements to repurchase are limited to 10 percent or less of the original pool balance (except where loans 30 days or more past due are repurchased).

Deferred-tax assets that are dependent on future income or future events means:

(1) Deferred-tax assets arising from deductible temporary differences dependent upon future income that exceed the amount of taxes previously paid that could be recovered through loss carrybacks if existing temporary differences (both deductible and taxable and regardless of where the related tax-deferred effects are recorded on the institution's balance sheet) fully reverse;

(2) Deferred-tax assets dependent upon future income arising from operating loss and tax carryforwards;

(3) Deferred-tax assets arising from temporary differences that could be recovered if existing temporary differences that are dependent upon other future events (both deductible and taxable and regardless of where the related tax-deferred effects are recorded on the institution's balance sheet) fully reverse.

Direct credit substitute means an arrangement in which an institution assumes, in form or in substance, credit risk directly or indirectly associated with an on-or off-balance sheet asset or exposure that was not previously owned by the institution (third-party asset) and the risk assumed by the institution exceeds the pro rata share of

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the institution's interest in the third-party asset. If the institution has no claim on the third-party asset, then the institution's assumption of any credit risk is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(1) Financial standby letters of credit that support financial claims on a third party that exceed an institution's pro rata share in the financial claim;

(2) Guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed an institution's pro rata share in the financial claim;

(3) Purchased subordinated interests that absorb more than their pro rata share of losses from the underlying assets;

(4) Credit derivative contracts under which the institution assumes more than its pro rata share of credit risk on a third-party asset or exposure;

(5) Loans or lines of credit that provide credit enhancement for the financial obligations of a third party;

(6) Purchased loan-servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Servicer cash advances as defined in this section are not direct credit substitutes; and,

(7) Clean-up calls on third-party assets. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the institution are not direct credit substitutes.

Direct lender institution means an institution that extends credit in the form of loans or leases to eligible borrowers in its own right and carries such loan or lease assets on its books.

Externally rated means that an instrument or obligation has received a credit rating from at least one NRSRO.

Face amount means:

(1) The notional principal, or face value, amount of an off-balance sheet item;

(2) The amortized cost of an asset not held for trading purposes; and

(3) The fair value of a trading asset.

Financial asset means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an

entity, or a contract that conveys a right to receive from or exchange cash or another financial instrument with another party.

Financial standby letter of credit means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

(1) To repay money borrowed by, or advanced to, or for the account of, a second party (the account party); or

(2) To make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

Government agency means an agency or instrumentality of the United States Government whose obligations are fully and explicitly 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 guaranteed by the full faith and credit of the United States Government, including but not limited to any Government-sponsored enterprise.

Institution means a Farm Credit Bank, Federal land bank association, Federal land credit association, production credit association, agricultural credit association, Farm Credit Leasing Services Corporation, bank for cooperatives, agricultural credit bank, and their successors.

Nationally recognized statistical rating organization (NRSRO) means a rating organization that the Securities and Exchange Commission recognizes as an NRSRO.

Non-OECD bank means a bank and its branches (foreign and domestic) organized under the laws of a country that does not belong to the OECD group of countries.

Nonagreeing association means an association that does not have an allotment agreement in effect with a Farm Credit Bank or agricultural credit bank pursuant to § 615.5207(b)(2).

OECD means the group of countries that are full members of the Organization for Economic Cooperation and Development, regardless of entry date, as well as countries that have concluded special lending arrangements with the International Monetary Fund's General Arrangement to Borrow, excluding any country that has rescheduled its external sovereign debt within the previous 5 years.

OECD bank means a bank and its branches (foreign and domestic) organized under the laws of a country that belongs to the OECD group of countries. For purposes of this subpart, this term includes U.S. depository institutions.

Preferred stock means stock that is permanent capital and has dividend and/or liquidation preference over common stock.

Performance-based standby letter of credit means any letter of credit, or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer to make payment as a result of any default by a third party in the performance of a non-financial or commercial obligation.

Permanent capital, subject to adjustments as described in §615.5207, includes:

- (1) Current year retained earnings;
- (2) Allocated and unallocated earnings (which, in the case of earnings allocated in any form by a System bank to any association or other recipient and retained by the bank, must be considered, in whole or in part, permanent capital of the bank or of any such association or other recipient as provided under an agreement between the bank and each such association or other recipient);
- (3) All surplus;
- (4) Stock issued by a System institution, except:
 - (i) Stock that may be retired by the holder of the stock on repayment of the holder's loan, or otherwise at the option or request of the holder;
 - (ii) Stock that is protected under section 4.9A of the Act or is otherwise not at risk;
 - (iii) Farm Credit Bank equities required to be purchased by Federal land bank associations in connection with

stock issued to borrowers that is protected under section 4.9A of the Act;

(iv) Capital subject to revolvement, unless:

(A) The bylaws of the institution clearly provide that there is no express or implied right for such capital to be retired at the end of the revolvement cycle or at any other time; and

(B) The institution clearly states in the notice of allocation that such capital may only be retired at the sole discretion of the board of directors in accordance with statutory and regulatory requirements and that no express or implied right to have such capital retired at the end of the revolvement cycle or at any other time is thereby granted;

(5) [Reserved]

(6) Financial assistance provided by the Farm Credit System Insurance Corporation that the FCA determines appropriate to be considered permanent capital; and

(7) Any other debt or equity instruments or other accounts the FCA has determined are appropriate to be considered permanent capital. The FCA may permit one or more institutions to include all or a portion of such instrument, entry, or account as permanent capital, permanently or on a temporary basis, for purposes of this part.

Qualified residential loan—

(1) The term qualified residential loan means:

(i) A rural home loan, as authorized by §613.3030, and

(ii) A single-family residential loan to a bona fide farmer, rancher, or producer or harvester of aquatic products.

(2) A qualified residential loan must be secured by a separate first lien mortgage or deed of trust on the residential property alone (not on any adjoining agricultural property or any other nonresidential property), must have been approved in accordance with prudent underwriting standards suitable for residential property, must not be past due 90 days or more or carried in nonaccrual status, and must have a monthly amortization schedule. In addition, the mortgage or deed of trust securing the residential property must be written and recorded in accordance with all state and local requirements governing its enforceability as a first

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lien and the secured residential property must have a permanent right-of-way access.

Qualifying bilateral netting contract means a bilateral netting contract that meets at least the following conditions:

- (1) The contract is in writing;
- (2) The contract is not subject to a walkaway clause, defined as a provision that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract;
- (3) The contract creates a single obligation either to pay or receive the net amount of the sum of positive and negative mark-to-market values for all derivative contracts subject to the qualifying bilateral netting contract;
- (4) The institution receives a legal opinion that represents, to a high degree of certainty, that in the event of legal challenge the relevant court and administrative authorities would find the institution's exposure to be the net amount;
- (5) The institution establishes a procedure to monitor relevant law and to ensure that the contracts continue to satisfy the requirements of this section; and
- (6) The institution maintains in its files adequate documentation to support the netting of a derivatives contract.

Qualifying securities firm means:

- (1) A securities firm incorporated in the United States that is a broker-dealer that is registered with the Securities and Exchange Commission (SEC) and that complies with the SEC's net capital regulations (17 CFR 240.15c3-1); and
- (2) A securities firm incorporated in any other OECD-based country, if the institution is able to demonstrate that the securities firm is subject to supervision and regulation (covering its direct and indirect subsidiaries, but not necessarily its parent organizations) comparable to that imposed on depository institutions in OECD countries. Such regulation must include risk-based capital requirements comparable to those imposed on depository institu-

tions under the Accord on International Convergence of Capital Measurement and Capital Standards (1988, as amended in 1998) (Basel Accord).

Recourse means an institution's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold (in accordance with GAAP) that exceeds a pro rata share of the institution's claim on the asset. If an institution has no claim on an asset it has sold, then the retention of any credit risk is recourse. A recourse obligation typically arises when an institution transfers assets in a sale and retains an explicit obligation to repurchase assets or to absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if an institution provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include, but are not limited to:

- (1) Credit-enhancing representations and warranties made on transferred assets;
- (2) Loan-servicing assets retained pursuant to an agreement under which the institution will be responsible for losses associated with the loans serviced. Servicer cash advances as defined in this section are not recourse obligations;
- (3) Retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets;
- (4) Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;
- (5) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;
- (6) Credit derivatives issued that absorb more than the institution's pro rata share of losses from the transferred assets; and
- (7) Clean-up call on assets the institution has sold. However, clean-up calls that are 10 percent or less of the

original pool balance and that are exercisable at the option of the institution are not recourse arrangements.

Residual interest—

(1) The term residual interest means any on-balance sheet asset that:

(i) Represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise; and

(ii) Exposes an institution to credit risk directly or indirectly associated with the transferred asset that exceeds a pro rata share of the institution's claim on the asset, whether through subordination provisions or other credit enhancement techniques.

(2) Residual interests generally include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests (and other forms of overcollateralization), and similar assets that function as a credit enhancement.

(3) Residual interests further include those exposures that, in substance, cause the institution to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold.

(4) Residual interests generally do not include interests purchased from a third party. However, purchased credit-enhancing interest-only strips are residual interests.

Risk-adjusted asset base means the total dollar amount of the institution's assets adjusted in accordance with § 615.5207 and weighted on the basis of risk in accordance with §§ 615.5211 and 615.5212.

Risk participation means a participation in which the originating party remains liable to the beneficiary for the full amount of an obligation (e.g., a direct credit substitute) notwithstanding that another party has acquired a participation in that obligation.

Rural Business Investment Company has the definition given in 7 U.S.C. 2009cc(14).

Securitization means the pooling and repackaging by a special purpose entity or trust of assets or other credit exposures that can be sold to investors.

Securitization includes transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

Servicer cash advance means funds that a mortgage servicer advances to ensure an uninterrupted flow of payments, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the loan. A servicer cash advance is not a recourse obligation or a direct credit substitute if:

(1) The servicer is entitled to full reimbursement and this right is not subordinated to other claims on the cash flows from the underlying asset pool; or

(2) For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal amount on that loan.

Stock means stock and participation certificates.

Term preferred stock means preferred stock with an original maturity of at least 5 years and on which, if cumulative, the board of directors has the option to defer dividends, provided that, at the beginning of each of the last 5 years of the term of the stock, the amount that is eligible to be counted as permanent capital is reduced by 20 percent of the original amount of the stock (net of redemptions).

Total capital means assets minus liabilities, valued in accordance with generally accepted accounting principles, except that liabilities do not include obligations to retire stock protected under section 4.9A of the Act.

Traded position means a position retained, assumed, or issued that is externally rated, where there is a reasonable expectation that, in the near future, the rating will be relied upon by:

(1) Unaffiliated investors to purchase the position; or

(2) An unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan, or repurchase agreement.

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U.S. depository institution means branches (foreign and domestic) of federally insured banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and United States territories and possessions. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, international banking facilities of domestic depository institutions, and U.S.-chartered depository institutions owned by foreigners. The definition excludes branches and agencies of foreign banks located in the U.S. and bank holding companies.

[70 FR 35348, June 17, 2005, as amended at 70 FR 53908, Sept. 13, 2005]

§ 615.5205 Minimum permanent capital standards.

Each institution shall at all times maintain permanent capital at a level of at least 7 percent of its risk-adjusted asset base.

[62 FR 4446, Jan. 30, 1997]

§ 615.5206 Permanent capital ratio computation.

(a) The institution's permanent capital ratio is determined on the basis of the financial statements of the institution prepared in accordance with generally accepted accounting principles except that the obligations of the Farm Credit System Financial Assistance Corporation issued to repay banks in connection with the capital preservation and loss-sharing agreements described in section 6.9(e)(1) of the Act shall not be considered obligations of any institution subject to this regulation prior to their maturity.

(b) The institution's asset base and permanent capital are computed using average daily balances for the most recent 3 months.

(c) The institution's permanent capital ratio is calculated by dividing the institution's permanent capital, adjusted in accordance with § 615.5207 (the numerator), by the risk-adjusted asset base (the denominator) as determined in § 615.5210, to derive a ratio expressed as a percentage.

(d) Until September 27, 2002, payments of assessments to the Farm Credit System Financial Assistance Corporation, and any part of the obligation to pay future assessments to the Farm Credit System Financial Assistance Corporation that is recognized as an expense on the books of a bank or association, shall be included in the capital of such bank or association for the purpose of determining its compliance with regulatory capital requirements, to the extent allowed by section 6.26(c)(5)(G) of the Act. If the bank directly or indirectly passes on all or part of the payments to its affiliated associations pursuant to section 6.26(c)(5)(D) of the Act, such amounts shall be included in the capital of the associations and shall not be included in the capital of the bank. After September 27, 2002, no payments of assessments or obligations to pay future assessments may be included in the capital of the bank or association.

[70 FR 35351, June 17, 2005]

§ 615.5207 Capital adjustments and associated reductions to assets.

For the purpose of computing the institution's permanent capital ratio, the following adjustments must be made prior to assigning assets to risk-weight categories and computing the ratio:

(a) Where two Farm Credit System institutions have stock investments in each other, such reciprocal holdings must be eliminated to the extent of the offset. If the investments are equal in amount, each institution must deduct from its assets and its total capital an amount equal to the investment. If the investments are not equal in amount, each institution must deduct from its total capital and its assets an amount equal to the smaller investment. The elimination of reciprocal holdings required by this paragraph must be made prior to making the other adjustments required by this section.

(b) Where a Farm Credit Bank or an agricultural credit bank is owned by one or more Farm Credit System institutions, the double counting of capital is eliminated in the following manner:

(1) All equities of a Farm Credit Bank or agricultural credit bank that have been purchased by other Farm Credit institutions are considered to be