FEDERAL RESERVE BANK OF DALLAS

2200 N. PEARL ST.

DALLAS, TX 75201-2272

November 7, 2005

Notice 05-70

TO: The Chief Executive Officer of each financial institution and foreign banking organization in the Eleventh Federal Reserve District

SUBJECT

Guidance on the Examination Treatment of Assets Related to the Tobacco Transition Payment Program

DETAILS

The Board of Governors has issued guidance to examiners regarding the proper treatment of assignments of tobacco transition payments and successor-in-interest contract payments under the U.S. Department of Agriculture's (USDA) Tobacco Transition Payment Program (TTPP or Tobacco Buyout Program) in the assessment of risk management, as well as for the purposes of regulatory reporting and capital. The Tobacco Reform Act established the TTPP. The legislation permanently ended the federal tobacco marketing quota and price support loan programs. To facilitate the transition of tobacco farmers from subsidized farming to an open market, the USDA will oversee the disbursement, through the Commodity Credit Corporation (CCC), of approximately $9.6 billion in Tobacco Buyout Program payments to eligible beneficiaries. The Tobacco Buyout Program will provide for payments, expected to be financed by assessments on manufacturers and importers of tobacco products, to eligible beneficiaries for a ten-year period commencing in 2005.

The USDA has identified sixteen states that this legislation will affect. These states are Alabama, Arkansas, Florida, Georgia, Indiana, Kansas, Kentucky, Missouri, North Carolina, Ohio, Oklahoma, South Carolina, Tennessee, Virginia, West Virginia, and Wisconsin.

ATTACHMENTS

A copy of the Board's SR letter 05-21, dated November 2, 2005, and the Board's guidance are attached.

MORE INFORMATION

For more information, please contact James Dean, (214) 922-6237, Banking Supervision Department. Previous Federal Reserve Bank notices are available on our web site at **www.dallasfed.org/banking/notices/index.html** or by contacting the Public Affairs Department at (214) 922-5254.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND
REGULATION

SR 05-21
November 2, 2005

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK, AND TO BANKING ORGANIZATIONS SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: Guidance on the Examination Treatment of Assets Related to the Tobacco Transition Payment Program

This letter sets forth guidance to examiners with regard to the proper treatment of assignments of tobacco transition payments and successor-in-interest contract payments under the U.S. Department of Agriculture's (USDA) Tobacco Transition Payment Program (TTPP or Tobacco Buyout Program)[1] in the assessment of risk management, as well as for the purposes of regulatory reporting and capital. The Tobacco Reform Act established the TTPP. The legislation permanently ended the federal tobacco marketing quota and price support loan programs. To facilitate the transition of tobacco farmers from subsidized farming to an open market, the USDA will oversee the disbursement, through the Commodity Credit Corporation (CCC), of approximately $9.6 billion in Tobacco Buyout Program payments to eligible beneficiaries. The Tobacco Buyout Program will provide for payments, expected to be financed by assessments on manufacturers and importers of tobacco products, to eligible beneficiaries for a ten-year period commencing in 2005.

The USDA has identified sixteen states that this legislation will affect. These states are: Alabama, Arkansas, Florida, Georgia, Indiana, Kansas, Kentucky, Missouri, North Carolina, Ohio, Oklahoma, South Carolina, Tennessee, Virginia, West Virginia, and Wisconsin.

The CCC does not have the legal authority to offer quota holders or producers lump sum payments.[2] Financial institutions and other third parties may, however, offer qualifying quota holders and producers a discounted lump sum payment in exchange for the right to receive one or more of the annual TTPP contract payments. A quota holder or producer holding an eligible TTPP contract can obtain a discounted lump sum from a financial institution through either an "assignment" of TTPP contract payments or by entering into a "successor-in-interest" contract with the CCC and a third party successor.[3] Under both an assignment and successor-in-interest contract, the annual TTPP contract payments are made directly to the financial institution.

Risk Management Considerations

Financing arrangements in the form of assignments and successor-in-interest contracts are essentially a discounting of a promissory note from the CCC to tobacco farm owners and farmers for all or a portion of the designated CCC promissory note payments. Banking organizations provide the discounted lump sum financing arrangement in exchange for the TTPP contract payment stream from the CCC. Examiners should ensure that such financing arrangements are made in a prudent manner with proper risk controls and management oversight. Accordingly, banking organizations should not fund any lump sum payments without first determining that the assignor, the successor contract, and the banking organization as either the assignee or successor meet all of the requirements of the TTPP and have been approved by the CCC, as applicable.

Before entering into an assignment of TTPP contract payments, a banking organization should ascertain the existence of any debts the assignor owes to any agency of the United States. Assignments, unlike successor-in-interest contracts, can expose a financial institution to credit risk because any debt a quota holder or producer owes to an agency of the United States will be offset against the TTPP contract payment stream. A banking organization should be able to document that it has conducted appropriate due diligence both before and during the life of an assignment. In addition, a banking organization, as assignee, should receive contractual commitments from the assignor that it will not incur any debt with an agency of the United States where such debt might result in offsets to the assignee's TTPP contract payments.

Regulatory Reporting

Banking organizations that enter into CCC-approved assignments or successor-in-interest contracts and make lump sum payments to quota holders and producers should report these financing arrangements as loans. The Supplemental Instructions for the June 30, 2005, Report of Condition & Income (Call Report), and for the June 30, 2005 Consolidated Financial Statements for Bank Holding Companies (FR Y-9C) state that banking organizations that enter into transactions should report these financing arrangements as "Loans to finance agricultural production and other loans to farmers" in Schedule RC-C, part 1, item 3; and FR Y-9C Schedule HC-C, item 3.[4] Banking organizations should recognize the discount reflected in these lump sum payments as interest over the life of the contract using the interest method.

Risk-Based Capital Treatment

Assignments of TTPP contract payments should be risk weighted at 100 percent because the bank is exposed to the risk that the quota holder or producer may fail to pay a debt to an agency of the United States resulting in a reduction in the amount to be paid under the assignment. Successor-in-interest contracts from quota holders and producers are, in essence, unconditionally guaranteed by the U.S. Government and should be risk weighted at zero percent. The Supplemental Instructions for the June 30, 2005 Call Report and for the FR Y-9C state that for risk-based capital purposes, TTPP assignments should be risk weighted at 100 percent and that successor-in-interest contracts should be risk weighted at zero percent.

Reserve Banks are asked to distribute this SR letter to domestic and foreign banking organizations supervised by the Federal Reserve in their districts as well as to supervisory and examination staff. Questions may be addressed to William Tiernay, Supervisory Financial Analyst, Division of Banking Supervision and Regulation, at (202) 872-7579 or Brendan Burke, Senior Financial Analyst, Division of Banking Supervision and Regulation, at (202) 452-2987.

Richard Spillenkothen
Director

Attachment: Transmitted electronically below.

APPENDIX

This appendix provides additional details about payments under the Tobacco Buyout Program, eligibility considerations, and contract details.

In accordance with the Tobacco Buyout Program, the CCC will make 10 annual TTPP contract payments to eligible quota holders and tobacco producers in each of the 2005 through 2014 fiscal years. To be eligible to receive a TTPP contract payment in 2005, tobacco producers and quota holders were required to sign up for the buyout program by June 17, 2005. Fiscal year 2005 TTPP contract payments were made between June and September of 2005. Subsequent to 2005, TTPP contract payments will be made in January of each fiscal year commencing with 2006.

TTPP Contract Eligibility

The complete eligibility requirements under the Tobacco Buyout program can be found at the USDA website. Of particular importance, the CCC must find that producers have complied during the years 2002, 2003, and 2004 with the statutory provisions relating to Highly Erodible Land Conservation (HELC), Wetland Conservation (WC), and Substance Control (SC).[5] If a producer is found not to be in compliance with these provisions during any one of the years 2002, 2003, or 2004, the CCC will not approve that producer's application for a TTPP contract. Quota holders do not have similar compliance-related contract eligibility requirements. However, to be eligible for the Tobacco Buyout program, a quota holder must have owned the farm (with an established 2004 marketing quota) on October 22, 2004.

Transfer of TTPP Contract Payments

The CCC will not approve assignments and successor-in-interest contracts unless the financial institution proposes to pay the quota holder or producer an amount greater than or equal to the discounted value of the remaining TTPP contract payments due. In any given year during the life of the program, the discounted value of the remaining TTPP contract payments due is based on a discount rate determined by the CCC in accordance with the Tobacco Reform Act. The maximum discount rate is the prime rate in effect on the first business day of the month plus two percentage points, rounded to the nearest whole number.[6]

Assignments

Quota holders and producers with eligible TTPP contracts may assign[7] the right to receive a TTPP contract payment, or portion thereof, to a third party of the assignor's choice. An assignment can be drawn up at any time in any given year during the remaining life of the Tobacco Buyout Program with a limit of two assignees per year. Assignments are revocable at any time with the assignee's consent.

Under an assignment, eligible quota holders and producers are subject to the offset provisions of the Debt Collection Improvement Act of 1996 (Debt Collection Act). Debt that a quota holder or producer owes to an agency of the United States at any time over the life of the contract will be offset with the assigned TTPP contract payments. Upon repayment of all quota holder or producer debt, any residual TTPP payments would revert to the assignee and be made in the order in which they were approved. Offsets of TTPP contract payments to extinguish quota holder or producer debts subject to the Debt Collection Act would expose a financial institution assignee to credit risk.

Successor-In-Interest Contracts

As an alternative to an assignment, quota holders and producers with eligible TTPP contracts may enter into a successor-in-interest contract with the CCC and a third party successor of the quota holder's or producer's choice.[8] A financial institution intending to succeed to a TTPP contract must first register with the CCC to obtain an account number. Before an account number is given by the CCC, the successor to a TTPP contract must have been found to have complied with the HELC, WC, and SC statutory provisions during the years 2002, 2003, and 2004. A successor found not to be in compliance with these provisions during 2002, 2003, or 2004, will not be eligible to participate as a successor-in-interest under the TTPP.

The CCC will not approve a successor-in-interest contract if either the quota holder or producer is subject to the offset provisions of the Debt Collection Act as a result of a debt to any agency of the United States. However, once the CCC has approved a successor-in-interest contract, annual payments made to the successor cannot be reduced by any subsequent debt the quota holder or producer may have to an agency of the United States. For this reason, successor-in-interest contracts do not pose the same credit risk to financial institutions as do assignments.

Financial institutions in their role as successors-in-interest are themselves subject to the offset provisions of the Debt Collection Act to the extent that debts are owed by the financial institution to the U.S. government. Debt a successor owes to an agency of the United States at any time over the life of the TTPP successor contract will be offset with TTPP contract payments due to the successor. Upon repayment of all successor debt, any residual TTPP contract payments would revert to the successor and be made in the order in which they were approved.

Quota holder and producer successor-in-interest contracts can be drawn up in any given year during the remaining life of the program. However, in order for a successor-in-interest contract to be effective for the following and successive year, the third party successor must file the contract with the CCC no later than November 1 of the preceding year. Once entered into, a successor-in-interest contract remains in force through fiscal year 2014, the last year in which TTPP contract payments will be made. Partial or single-year successor-in-interest contracts are not permitted. Although a successor-in-interest contract may not be revoked, the CCC will allow the sale of a successor-in-interest contract to another approved party (i.e., a Subsequent Successor).

Notes:

1. The Fair and Equitable Tobacco Reform Act (Tobacco Reform Act) was enacted into law on October 22, 2004, as part of the American Jobs Creation Act of 2004. Access to all TTPP information including sample contracts, lump sum conversion factors, Tobacco Transition Payment Program Final Rule (70 FR 17150 April 4, 2005), and program registration forms and procedures may be found at the tobacco information website at: http//www.fsa.usda.gov/tobacco. Additional program information can also be found in the Appendix to this guidance.

2. Quota holders are the landowners of a farm for which a tobacco quota was assigned for the 2004 marketing year. Producers include owners, operators, landlords, tenants, or sharecroppers who shared in the risk of producing tobacco during any of the 2002, 2003, or 2004 marketing years .

3. TTPP contract payments were made only under the assignment arrangement in fiscal year 2005. TTPP contract payments under successor-in-interest contracts do not begin until fiscal year 2006.

4. Nonbank subsidiaries of bank holding companies and foreign banking organizations should report these transactions as loans in the nonbank subsidiary reports of domestic banking organizations and in the financial reports of foreign banking organizations, respectively.

5. See 7 CFR Parts 12, 718.6 and 1400 relating to the protection of environmentally sensitive land and to statutes restricting the right to receive TTPP contract payments upon conviction of violating certain controlled substances statutes. Compliance with these provisions shall be based on the 2002, 2003, and 2004 crop years and not on any period thereafter.

6. The discount rate provision only applies to an original successor-in-interest contract. Subsequent successor purchases of TTPP contract payment streams can be based on market value.

7. An assignment to a third party transfers only the rights to the TTPP contract payment. Under such an arrangement, the quota holder or producer must continue to abide by the terms of the approved TTPP contract with the CCC.

8. Under a successor-in-interest contract, ownership of the payment contract is transferred to the successor with all rights and obligations. The original contract holder (i.e., a quota holder or producer) no longer remains a party to the program or its benefits.